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HOSTILE TAKEOVERS

HEARINGS

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE EXAMINATION OF THE NEED FOR REFORM OF THE PROCEDURES AND PRACTICES OF INSIDER TRADING, FINANCING OF HOSTILE TAKEOVERS AND THEIR EFFECTS ON THE ECONOMY AND INTERNATIONAL COMPETITIVENESS

JANUARY 28, MARCH 4, AND APRIL 8, 1987

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HOSTILE TAKEOVERS

WEDNESDAY, JANUARY 28, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Sarbanes, Dixon, Sasser, Sanford, Shelby, Graham, Garn, Heinz, D'Amato, Hecht, and Chafee.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Today we begin our first in a series of hearings on the economy, insider trading and hostile junk bond financed corporate takeovers.

The lead story on the very first day of this new year, in virtually every major newspaper in the country, was that the trade deficit grew to a record horrendous $19.22 billion level in November, just 1 month. The total for the year 1986 is expected to reach an equally disastrous record level of $174 billion.

It is estimated that in 1986 for the first time ever the total cost of acquisitions, as in mergers and acquisitions, will exceed $150 billion. This will exceed spending on plant and equipment. In 1986, American manufacturers will spend only $140 billion on plant and equipment. Let me repeat that. Mergers and acquisitions $150 billion; plant and equipment expenditures only $140 billion. This is the first time such an anomaly has occurred.

So is it any wonder that our competitive position in world markets is suffering? To many Americans the disclosure that arbitrageur Ivan Boesky was using confidential information from Dennis Levine proved what had long been suspected: that millions in takeover profits have been going to those who rigged the game.

But many people's suspicions go a whole lot deeper. There is an increasingly prevalent suspicion that at least a part of the takeover game has been rigged by a cast of characters—in another era they might have been called a pool—who deliberately put a company into play, based on highly suspect financing, manipulate the market and then get out with their profits intact, claiming all the way to the bank that they are solid Americans doing the country some great favor.

In most of these cases, of course, nothing is taken over but the people behind the pool walk away with millions of dollars.

In the hearings this committee will be holding at the full committee level on these subjects over the next 2 years we will be looking into a number of different issues.

A general ongoing theme will be an examination of the need for reform of the procedures, practices, and financing of hostile takeovers as well as an examination of hostile takeovers and their effects on the economy and America's international competitiveness.

We will be examining the financing of tender offers with particular attention being paid to margin regulations, the use of junk bonds in these deals, the role played by highly confident letters, investment banker bridge loans, bank loans and the tax deductibility of takeover debt.

The impact of hostile corporate takeovers on corporate debt as well as on capital investment, research and development, and employment will be reviewed as will the relationship between bankers, raiders, and arbitrageurs. I am interested in learning more about the possible cooperation and exchange of information between these groups, any relationship or cooperation regarding their junk bond financing commitments, and any breakdown of the so-called Chinese wall which is supposed to separate the various research, sales, trading, arbitrageur, and other activities of the financial community.

More specifically, I am interested in whether or not the investment bankers, in some instances, promote raids. With respect to the junk bond market, I believe we must learn exactly who are the issuers, who are the buyers, how the secondary market works, and what interlocking relationships, if any, exist between issuers, investors, and underwriters.

Today we will hear first from a highly distinguished panel. These will be the first witnesses and certainly among the very most distinguished that we will hear in the next couple of years on these issues. This panel's members have all been helpful to the committee in the past and we believe they will be helpful to us again as we proceed to examine the need for reform in the takeover system.

Our first panel includes Alan Greenspan, chairman of Townsend-Greenspan; Nicholas Brady, our former highly respected colleague and chairman of the board of Dillon, Read & Co.; Felix Rohatyn, senior partner at Lazard Freres; and Lloyd Cutler, senior partner in the law firm of Wilmer, Cutler & Pickering.

Now I had a much longer and even more brilliant opening statement, but because of the time and because we want to hear from our witnesses, I will submit that for the record.

[The complete prepared statement follows:]

Senator William Proxmire

Hearing on Hostile Corporate Takeovers

January 28, 1987

Today we begin our first in a series of hearings on the economy, insider trading and hostile junk-bond financed corporate takeovers.

The lead story on the very first day of this new year, in virtually every major newspaper in the country, was that the trade deficit grew to a record horrendous $19.22 billion in November. The total for the year 1986 is expected to reach an equally disastrous record $174 billion.

What does this mean? It means quite simply that, among other things, the United States is not producing what the rest of the world wants, and that the rest of the world is producing what we want -- and at a better price.

How to make the United States more competitive and more productive is a question that every United States Senator and, for that matter, every concerned American citizen must ask him or herself.

At exactly the same time as our trade position is deteriorating we are experiencing a 1920s-like go-go style casino atmosphere in our financial community. The financiers of this country have clearly managed not only to gain the upper hand over our manufacturing sector, but in the process to raid and terrorize them as well. It is small wonder then that at a time when almost one major American company a week is being put into play, corporate America is more concerned with making itself less attractive to a would-be hostile takeover or corporate raider than producing or manufacturing a better product.

It is also no small wonder that at the same time as we are seeing unprecedented scandals on Wall Street, rampant insider trading, and individuals -- not corporations, but individuals mind you raising billions of dollars one week and then another billion dollars a few months later to play the hostile corporate takeover game -- that our international competitive position is suffering.

Meanwhile corporate raiders, who produce little, but trade a lot of paper, make off with tens and sometimes hundreds of millions of dollars, while leaving thousands of corporate employees out of work. And more often than not these fellows don't even take over a company. They saddle it with unprecedented amounts of debt. And they put up little of their own money in the process.

Take a look at the record of one of the more famous of these raiders. He makes $40 million on one deal, $32 million on another, $45 million on another, $500 million and $80 million on others.

And he doesn't take over a single one of these companies. His exploits leave one company with an additional $4.0 billion in debt another with an additional $4.5 billion in debt, and the list goes on. In one instance over 3,000 jobs are eliminated, and in another over 17,000.

The justification for this activity is that it is making American industry leaner and meaner and that the resulting restructuring is making the United States more competitive. Maybe. And maybe America's entire corporate establishment is as entrenched as it is charged with being. I certainly have never had any great love affair with corporate management. But I am highly skeptical of the argument. Of course, there is some good which is resulting from the current hostile takeover frenzy. But it would not greatly surprise me, if we found that there was a great deal more harm and that our economy was suffering as a result.

Nobel prize winner James Tobin for one has pointed out that many of our best minds these days are being attracted to the investment banking community because of the million dollar salaries available, when the country might be better served by their going into more productive fields. He has confessed:

> "To an uneasy suspicion we're throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity."

Similarly, Warren A. Law, a professor of banking finance at Harvard Business School, has testified to his concern that

> "Increasing amounts of our scarcest resource - brain power - are being devoted to playing games. Our brightest young people are being lured into this game by the inordinate legal and financial fees involved. And good managers are forced to spend time in unproductive ways, to avoid being raided, rather than activities of social benefit."

At the same time as this "brain-drain" to the financial community is going on we read that our trade picture and international competitive position is deteriorating and wonder why.

Does anyone believe that the best and the brightest and the cream of the society of our trading competitors in Taiwan and Korea and Japan are going into pushing paper as opposed to making products? Why is it that half the science and technology graduates of our universities are foreigners and that while our productivity has been growing at 2.7 percent, the Japanese has been growing at 8 percent?

It is estimated that in 1986, for the first time ever, the total cost of acquisitions -- $150 billion -- will have exceeded plant and equipment spending -- $140 billion -- by America's manufacturers. Is it any wonder that our competitive position in world markets is suffering.

To many Americans the disclosure that arbitrager Ivan Boesky was using confidential information from Drexel Burnham Lambert investment banker Dennis Levine proved what had long been suspected: that millions in takeover profits have been going to those who rigged the game.

But many people's suspicions go a whole lot deeper. There is an increasingly prevalent suspicion that at least a part of the takeover game has been rigged by a cast of characters -- in another era they might have been called a pool - who deliberately put a company into play, based on highly suspect financing, manipulate the market and then get out with their profits in tact, claiming all the way to the bank that they are solid Americans doing the country some great favor.

Ivan Boesky, Dennis Levine and the ongoing SEC investigation indicate that we might well be advised to be highly skeptical of such claims. I definitely am.

In the hearings this Committee will be holding at the full Committee level on these subjects we will be looking into a number of different issues.

A general ongoing theme will be an examination of the need for reform of the procedures, practices and financing of hostile takeovers as well as an examination of hostile takeovers and their effects on the economy and international competitiveness.

We will be examining the financing of tender offers with particular attention being paid to margin regulations, the use of junk bonds in these deals, the role played by "highly confident letters", investment banker bridge loans, bank loans and the tax deductibility of takeover debt.

The impact of hostile corporate takeovers on corporate debt as well as on capital investment, research and development and employment will be reviewed as will the relationship between bankers, raiders and arbitrageurs. I am interested in learning more about the possible cooperation and exchange of information between these groups, any relationship or cooperation regarding their junk bond financing commitments, and any breakdown of the "Chinese Wall" which is supposed to separate the various research, sales, trading, arbitrageur and other activity of the financial community.

I think another question, which must be asked is how dependent have investment bankers and Wall Street dealmakers become on this hostile takeover business. It might be interesting to examine the percentage of a couple of firm's revenues and profits resulting from these deals together with their compensation and salary scales. I think that sooner or later the question must be asked as to whether or not there is an overriding need on the part of some investment banking firms to create these deals to stay profitable, notwithstanding any conclusive provable benefits to the United States economy.

More specifically, I am interested in whether or not investment bankers, in some instances promote "raids". With respect to the junk bond market, I believe that we must learn exactly who are the issuers, who are the buyers, how does this secondary market work, and what interlocking relationships, if any, exist between issuers, investors and underwriters.

It used to be that one million dollars was a lot of money. To most of us $10 million is still a great deal, $100 million is obviously more -- $500 million, and now we are really talking money. But today a single arbitrageur or individual corporate raider can raise billions of dollars with a blink of an eye and then do it again in the same year. How is this possible? Other issues which will be the topic of Committee examination include the subject of leveraged buyouts - their fairness to shareholders, and the reasons for them; the entire matter of greenmail; the institutional investors control of major public companies including their short-term versus long-term orientation; and the role of the thoughtful corporate businessman and his fear of a hostile takeover versus his plans for expansion.

I suspect that the deeper we get into the subject the more we will find.

Today we start on our journey toward examining some of these issues.

I am heartened at the outset that many responsible people see the need for a thorough review. Take, for example, John Phelan, the Chairman of the New York Stock Exchange. He has suggested that "it would seem prudent to explore whether the takeover process itself should be slowed down." He has recommended "shortening the time in which important information about a takeover is in the hands of only a few people" and he has advocated "getting more sunlight into the arena faster. And letting as many people as possible know at the same time what's happening in the marketplace."

More importantly, he has stated that in his opinion "there's a structural problem in our system that needs to be addressed."

According to Mr. Phelan "as we move away from the specifics of the Boesky case, what we see is a relatively new phenomenon in which investment bankers, institutions, arbitrageurs, accounting firms, public relations firms and law firms join together in takeover activities. And in which enormous sums of money are in the balance."

The Chairman of the New York Stock Exchange goes on that "This certainly raises the issue of an increased risk not only of insider trading, but of manipulation. Or what might be called modern pool activities."

I think John Phelan is perfectly correct in this assessment, and at a later date the Committee will look forward to hearing from him and receiving his specific recommendations on the issues he has raised.

But today we will hear first from a highly distinguished panel whose members have all been helpful to the Committee in the past and who we believe will be helpful to us again now in examining the need for any reform in the system. Our first panel includes Alan Greenspan, Chairman of Townsend-Greenspan; Nicholas F. Brady, former Republican Senator from New Jersey and Chairman of the Board of Dillon Read & Company, Inc.; Felix Rohatyn, Senior Partner at Lazard Freres; and Lloyd Cutler, Senior Partner in the law firm of Wilmer, Cutler & Pickering.

Our second panel is composed of three former SEC Commissioners including former Chairman Roderick M. Hills and former Commissioners Al Sommer and Francis Wheat.

The **Chairman**. Senator Heinz, do you have an opening statement?

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, I do, and first I want to compliment you on starting these hearings. This is, in my mind, an extremely significant inquiry. I would note that over the last 4 years, the United States has witnessed the greatest reshuffling of corporate assets in its history.

It is a gigantic business. I see we have some of the best practitioners and observers of it at the witness table.

In the last 4 years, some 12,200 companies and corporate divisions worth over $½ trillion—not million, not billion—but $½ trillion have changed hands.

In the process, corporate debt has skyrocketed and I think the question that many of us have in our minds is fundamentally this. In all the debt that has been created, has American business and its advisers somehow achieved the mortgaging of the future of American business, our competitiveness, and therefore the basic strength of this country?

Mr. Chairman, let me elaborate very briefly on what I see.

First, I think the takeover binge has subsided somewhat due to changes in the Tax Code last year and to the insider trading scandal that rocked Wall Street. This is a very good time to assess what has happened the last few years and what has happened to our economy through this restructuring.

I would like to make sure that we get answers to the questions such as, is American industry leaner and more competitive as a result of this or is it more concentrated? Does it matter that foreign companies spent $18 billion buying American companies last year? Has speculative lending for corporate takeovers adversely affected our domestic credit markets or threatened this country's financial stability or absorbed credit that would benefit other people seeking credit?

Now we have seen a marked improvement in our economy over the last several years. Inflation is down. Real interest rates and the value of the dollar are down. The Dow Jones has hit a new high. But I must say I remain concerned about the usefulness of merger activities which provide no demonstrable increase in efficiency, or productivity, or technological improvement.

It seems that there are all too many instances where a merger or its attempt leaves a company in a weakened rather than a strengthened financial position.

Now, there are advocates of corporate restructuring who contend that many have benefited, and that may be true. There are statistics often cited that shareholders have benefited, often paid an average of a 40 percent premium on their stock in such takeover deals. There is the contention that the mere threat of a takeover has shaken up complacent managements that needed stirring up, and that has made for more efficient operations.

Shareholders of those acquired companies may well have benefited, but there have been some other bigger winners as well. One of the big winners are those who pocketed greenmail or the ones who bought up and broke up the target firm, usually at a substantial profit; or the arbitrageur, or the investment bankers, or the takeover lawyers, or Ivan Boesky. His deals weren't done for the purpose of shaking up management. They appear to have been made for the totally illegal and unethical reason of making a quick buck.

We should assess who the losers are in this process. It's my judgment that companies should be planning for the long term instead of finding themselves diverting money and brainpower into the financial guerrilla warfare of takeover strategies. Today, corporate management's focus is not even on the fiscal quarter. It's on a preposterously short time horizon. It's on the day and what to do about it and how to survive it.

I have a number of other concerns, Mr. Chairman. I hope these hearings will shed a good deal of light on whether or not we are mortgaging the future of this country. Certainly the growing national debt is mortgaging the future of this country. Certainly the growing debt to other countries brought about as a result of our trade deficits at record levels in 1986 is mortgaging this country to the ownership of others. And consumer debt has certainly mortgaged a lot of consumers and their ability to be consumers in the future.

The question is, has American business fallen into the same trap? I hope not, but there is every indication that they may well have done so. The rest of us have seen far too many examples of others doing it and maybe it's a disease that everybody has caught.

The CHAIRMAN. Thank you, Senator Heinz, for a very fine opening statement.

Senator Sanford, do you have an opening statement?

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Well, I don't want to repeat anything you've said, but let me just say that I think that we are engaged now in something that's crucially important to the corporate strength of America. I have been disturbed for a long time by the reckless approach that we have seen develop under a period of deregulation.

I think Mr. Rohatyn is going to speak to this in a way that pretty well is in line with my thinking. He speaks of a cancer and the cancer is greed. In addition, there is no question that a transfer of so much equity to debt is extremely dangerous to the economy.

There is also no question that the attitude that the only thing about a corporation is the stock ownership and that the stockholder is supreme misses a very important part of American enterprise. That is, that a corporation isn't just something that can be manipulated through stock ownership, but it's something that has a great deal to do with the lives of so many Americans. It's something that has so much to do with the stability of communities. It has so much to do with the soundness of our economy that you can't say that it's quite all right to dismantle that corporation if somebody is clever enough to do it. We have seen that degree of cleverness grow to the point where people can take with leveraged buyouts or partially-funded takeovers where a great number of the stockholders are left out of it. In such transactions, we put as paramount the ownership of the stock and forget all about the broader social purposes of corporations in America.

I think that we have listened to glib explanations that such takeovers are the way that we get better management. All one need do is simply look at the petroleum business in this country to see that the prime offender has made a great deal out of getting rid of sleepy management. Well, sleepy management is better than no management and we've seen the petroleum industry move to a situation that is much less sound than it was 5 years ago.

There is no question in my mind that we have got to regulate takeovers, that we have got to make certain that takeovers are done with a broader view of the place of corporations in society, and I look forward to the kind of legislation that will help us achieve that.

The CHAIRMAN. Thank you, Senator Sanford.

Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I want to commend you, Mr. Chairman, for your leadership in addressing early in the 100th Congress the ramifications of hostile takeovers.

I believe that the question here today is this: is there a public policy benefit to all this hostile takeover activity or, on the other hand, is it solely to the benefit of making millions for those corporate raiders who never gave up the game of monopoly?

I also think that we ought to determine if someone has removed all the "Go directly to jail" cards that we used to see.

The recent wave of hostile takeovers raises serious public policy questions such as: concentration of power, unproductive use of resources, fairness to consumers and shareholders, and the long-term interest of our economic foundation.

These concerns are particularly relevant as America strives to maintain its competitive edge in the global marketplace.

I welcome our witnesses here today, Mr. Chairman, and look forward to hearing them respond to the question of whether hostile takeovers are criminal or simply capitalism in nature.

The CHAIRMAN. Thank you very much, Senator Shelby.

Senator Metzenbaum, we are delighted to have you. Senator Metzenbaum is not a member of the committee but he is certainly an expert in this area and I urged him to come to our hearing and I am very happy he accepted. Senator Metzenbaum, do you have an opening statement?

STATEMENT OF SENATOR HOWARD M. METZENBAUM, U.S. SENATOR FROM THE STATE OF OHIO

Senator METZENBAUM. If I may, Mr. Chairman. I will be very brief.

First, I want to commend you, Mr. Chairman, on your timeliness.

Last night we heard the President speak about the State of the Union and today, immediately following, you hold a hearing having to do with the state of the American business community. I can't think of any more appropriate timing nor any better message to send to the American people than that the Congress is concerned about what's happening in the American business world at the moment with respect to takeovers and poison pills and so many other issues that come up.

Our immediate and thoughtful consideration of this issue, as I see it, is essential in our work toward preventing the reoccurrence and the abuses that have recently occurred. I think that it is a matter of timing in the legislative process. When there are major issues that occur Congress is prepared to act, and as they fade from the front page and they get on the back page and then they get out of the public view entirely, then it seems that the sense of urgency isn't there as much. So I hope that we are going to move forward promptly and certainly this hearing today indicates that.

I want to thank you for recognizing that sense of urgency and for allowing me to participate.

We can no longer take seriously the argument that the way companies are bought and sold in this Nation is simply a healthy result of free market forces. Many corporate takeovers have nothing to do with improving management, nor increasing productivity, nor making the firm a better investment for the shareholders.

MANY TAKEOVERS ARE UNFAIR TO SHAREHOLDERS

Instead, we have seen too many takeover battles that have been unfair to shareholders and have damaged the company. The only real winners have been the corporate raiders who walked away with a fast fortune. Too often this fortune has been greenmail, the ransom required to make the raider go away.

But to say some takeover attempts have been harmful is not to conclude that we should ban them. I would not favor banning all efforts with respect to takeovers. We should not make it impossible for an outsider to take over a company just because management objects.

In our American economic system, the primary responsibility of corporations is to the shareholders who own them, not to the senior executives whose generous compensation depends on current ownership.

Too often, we overlook the interests of the small shareholder who owns 10, 20, or 100 shares of stock. They have put some of their hard-earned savings at risk to help a company grow. They deserve a say in what the corporation does. They deserve the opportunity to reap the rewards of an increase in the value of their stock if it results from a tender offer process that is fair.

The task for Congress is to balance these competing concerns. How do we do that? First, we can ban greenmail. There is a growing consensus that greenmail is unfair to shareholders and it attracts raiders who really aren't interested in improving the company.

Second, we can ensure that shareholders are given fair and equal treatment when a tender offer is made. For example, we can put some strong yet reasonable restrictions on partial and two-tiered tender offers and we can give the shareholders a longer period in which to respond.

Third, we should examine management decisions which are solely for the purpose of fighting off takeovers but which actually hurt the company and the shareholders.

The courts have limited management discretion in this area somewhat but I believe Congress should nevertheless set some basic ground rules for defensive tactics and poison pills.

We should seek that balanced approach, one both protective of shareholders and fair to management. It should not be a one-way street.

ANTITRUST REVIEW PROCESS

Finally, we should make sure the antitrust review process is adequate. For example, we should close the current loophole in the Hart-Scott-Rodino Act for partnership acquisitions. We should extend the time for antitrust review of cash tender offers and large mergers. And we should ensure that a company that is the subject of a takeover effort has standing to claim that the merger would violate the antitrust laws.

The antitrust law changes are within my subcommittee's jurisdiction and we hope and expect to move promptly.

Greenmail, two-tiered tender offers, poison pills, golden parachutes, and much more fall within this committee's jurisdiction. Last year I expected the committee would act. It didn't. Under your leadership, Mr. Chairman, I hope it will and soon and I pledge to you that I will do whatever I can to help and support you. We owe nothing less to the shareholders, to management, the employees, and the communities in which those businesses operate.

Last but not least, action soon, in my opinion, is an imperative for the success of the free enterprise system.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Metzenbaum.

Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, in order to expedite this hearing, I request that my statement be included in the record as if read in its entirety.

I would like to take this opportunity to commend our former colleague, Senator Brady, for his very thoughtful submission. He offers several thoughtful recommendations regarding amendments to the laws regulating corporate mergers. In fact many of his suggestions are contained in S. 227, the Tender Offer Reform Act which I introduced on January 6, 1987. When considering amendments to the Williams Act I hope we would not get into a rush for headlines as opposed to disciplined thinking in this area.

This morning the committee continues its examination of the impact of corporate takeovers on the American economy. Today's hearing will no doubt examine many of the same issues which the Securities Subcommittee explored during hearings that I chaired which were conducted on April 3, 4 and June 6, and 12, 1985. Those hearings culminated in a legislative package, S. 1907, the Tender Offer Reform Act of 1985.

Since the introduction of S. 1907, not much has changed in the world of corporate takeovers. Friendly and hostile offers and leveraged buyout continue although at a somewhat slower pace. The Tax Code has been altered somewhat and this will have an impact on corporate takeovers. However, certain abusive practices continue unabated and I believe that the role of this committee is to identify and eliminate those practices. That is what I set out to accomplish most recently in the introduction of S. 227, the Tender Offer Reform Act of 1987—a bill which embodies many of the same provisions of S. 1907. Hopefully, my colleagues will begin to examine the abusive practices this legislation was designed to remedy with more interest.

After reviewing the testimony before us this morning, I was particularly struck by the brilliance of Nick Brady's legislative recommendations which he mentions at the conclusion of his remarks. I hope my colleagues will also take note of these remarks. Perhaps unbeknowst to Senator Brady, he has accurately described and endorsed many of the provisions of S. 227, the Tender Offer Reform Act of 1986 which I introduced on January 6, 1987, and S. 230 and S. 231, bills which would define the term "insider trading" which were introduced on the same day. I congratulate Nick on his insightful analysis of the issues and for publicity which he has given my proposal. I hope that we can work together and ensure its passage in the near future.

The issues raised by corporate merger activity have sparked intense and heated debate. Due to the passions stirred by these issues, it is of utmost importance that both sides of the debate be heard. In short proponents of takeover activity argue that takeovers are good for the economy and opponents contend that takeovers have a detrimental impact on the economy.

In determining which side presents a stronger case on this issue, it is important to go beyond the anecdotal evidence which is so often presented before State Committees and look at the facts. In our effort to devise an appropriate legislative response to the issues discussed this morning, I recommend that we focus upon the economic realities rather than the perceptions related to corporate takeover activity.

These hearing should not focus upon issues regarding the advisability of certain types of takeover transactions. The Federal Government has been reluctant to play such a role in the initial passage of the Federal Securities laws and subsequent Amendments such as the Williams Act. Neither the witnesses who appeared before the Securities Subcommittee nor the testimony presented this morning has convinced me of the existence of a market failure in the market for corporate control. The marketplace evaluates and rejects flimsy, economically unjustifiable offers. While there are certainly mergers and takeovers that do not create the intended societal and economic benefits, the Federal Government is less capable of distinguishing between good and bad takeovers, than are private parties, who have better information and a substantial financial incentive to be right in making these judgments.

Absent a showing that market merchanisms have failed, I am not prepared to pass legislation that contravenes the purpose and intent of the Williams Act. The purpose of these hearings should be to identify the abuses which escape regulation under the existing regulatory framework.

As policy makers we must rely upon empirical evidence rather than rhetoric before we enact legislation that makes any major substantive changes to the Williams Act. Isolated anecdotes can be found to support any theory; and therefore prove none. To introduce some measure of empiricism to the discussion of these issues, I wish to introduce several studies and research articles into the record which present factual analyses of the impact of corporate takeovers on stockholders, corporate America, the funds spent on research and development, the growth of merger activity, the financing of corporate takeovers, the credit markets and the performance of American economy. Although I will not recite a litany of the factual conclusions of these reports and articles, I urge my colleagues to review this data before we make any final decisions. Data such as that provided in these studies will enable us to separate rhetoric from reality.

I ask unanimous consent that the reports and articles to which I referred be included in the record. Thank you Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator D'Amato.

Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the committee begins to consider issues related to corporate takeovers.

This is an issue with many facets. It brings in questions like insider trading, the role of arbitrageurs, shareholder democracy, long-term versus short-term corporate management objectives, basic corporate structure, debt versus equity in a corporate balance sheet, the role of junk bond financing, and the allocation of capital resources, to name just a few. It is an issue that plays a direct and significant role in determining our overall economic health and our international competitiveness.

I have been concerned for some time about the impacts of junk bond financed takeovers on corporate balance sheet. Some respected experts argue that these takeovers result in exchanging equity for debt, and the result is a weaker corporation less able to cope with the downside of the business cycle. It has also been strongly argued that takeovers force corporate managers to consider short-term profits above their long-term best economic interests.

On the other hand, corporate management, it seems to me, cannot be made immune from the kind of economic discipline that takeovers can represent. While it is a truism to say that corporations should be managed for their owners and not their managers, it is a truism that too-often does not seem to be true in the real world. All too often, corporate CEO's increase their salary when the company does well, but also when the company does poorly. Employees may be laid off, the stock price of a corporation can fall, hurting its shareholders, but some corporate managers seem able to protect themselves from the risks that buffet others, and that, it seems to me, is not what our free enterprise system is all about.

This is a long way of saying, Mr. Chairman, that I come to this hearing with an open mind. I look forward to hearing from the distinguished group of witnesses before the committee today, and to continuing to examine this issue with my colleagues on the committee and with all those who have an interest in it.

The CHAIRMAN. Mr. Greenspan, you have a plane to catch and you have only a few minutes I understand and I know all you gentlemen are very busy and have other appointments that you would like to keep if you possibly could. We're going to make this as concise as we possibly can while still covering the subject.

I'm going to ask Dr. Greenspan to speak first not to exceed nine minutes and then we will question Mr. Greenspan because he does have to leave. He has, as I say, a deadline. Then we will proceed with the other witnesses.

So, Mr. Greenspan, you go right ahead.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, TOWNSEND-GREENSPAN, NEW YORK, NY

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I very much appreciate your courtesy.

The extraordinary increase in recent years of mergers, acquisitions and the leveraged buyouts is a response to a significant incentive—the perception that the potential value of a takeover candidate could be substantially higher than the cost of acquisition. This potential profit derives mainly from the marked increase in the real cost of capital that occurred at the beginning of this decade, largely as a result of a widening structural budget deficit. While the real cost of capital, as measured either in debt or equity terms, presumably remains above normal, it has fallen a great deal recently. This suggests that the wave of mergers and acquisitions may now be cresting.

American industry generally has been structured in the context of approximately a historical 5 to 7 percent real cost of capital. Individual corporations, therefore, were structured so that the maximum use of resources would occur at that discount rate. An alternative higher capital cost does not generate the same optimum return, as indeed we are finding out at the moment.

While the cost of capital can change rapidly, the composition of fixed assets can be altered only slowly. One way to reestablish the maximum value use of facilities is to break apart companies, reconstituting them at their maximum use under the new higher cost of capital.

ROLE OF PREMIUMS IN TAKEOVERS

The ability to take over and reconstitute misaligned companies became, therefore, of considerable market value. As a consequence, the premiums in the stock market for control of companies began to rise very sharply. In the 1970's and earlier, the typical price premium on the critical mass of a company's shares required for control sold at perhaps 20 to 40 percent over the prevailing stock market values which were generated on the basis of investment in the facility as specifically constituted. In recent years, control premiums have risen to twice the market value of individual investment shares reflecting the profit in stock market values from restructuring a company. This has produced an enormous surge of takeover attempts. Any investor who could buy controlling interest in a company at less than the full control premium could profit from the difference between the acquisition price and the market value of the company under the new, restructured set of asset relationships.

With stock prices sharply higher and the real cost of capital declining during the past 2 years, premiums for control might have been expected to decline. In fact, the forces generating takeover incentives probably would have peaked, and the process might already be exhibiting significant contraction, were it not for the extraordinary expansion in financings coming from so-called junk bonds. This has extended the potential profit on takeovers and restructuring by expanding the number of potential corporate acquirers.

It's long been an oddity of corporate finance that risk premiums imposed on lower quality, higher yielding, corporate long-term obligations, currently dubbed junk bonds, have in recent years appeared to be larger than actual losses seemed to suggest was appropriate. As a consequence, issuers of such bonds were relatively few in number until recently. A decade ago, less than 5 percent of public corporate bonds outstanding were low-grade bonds. The market began to change radically a few years ago as investors, confronted with failng interest rates, began to look toward higher yielding lower grade bonds to maintain their interest incomes. As yield spreads came closer to actual loss experience, lower grade credits rapidly increased their share of total outstanding corporate debt to almost 15 percent.

Junk bonds eventually should rise to their appropriate share of corporate long-term obligations. At that point, the rate of increase in the quantity of such bonds outstanding should slow fairly dramatically. That, of course, will mean a fairly significant decline in the net new issues of junk bonds. Hence, the current junk bond explosion must be viewed as a one-shot market adjustment reflecting previous undervaluation. As higher yielding, higher risk obligations find their new niche in the market, their growth is likely to be more in line with overall corporate debt than with the frenetic pace of recent years. Since they will continue to be available to expanding corporations who are more risk prone, this will increase the overall risk of bond default.

HUGE INCREASE IN CORPORATE DEBT

Though the takeover, merger, acquisition frenzy probably is in the process of cresting, and is likely to decline as a result of the sharp increase in stock prices, in its wake the process has left a significant deterioration of the corporate sector. As a consequence of mergers, acquisitions, leveraged buyouts, and corporate stock repurchase programs, the net liquidation of nonfinancial corporate equities has approximated an incredible $230 billion since the beginning of 1984. As the asset side of the corporate balance sheet has continued to expand, the equity liquidation has, in effect, been a substitution of debt. While all of the debt accumulation has not reflected takeover and merger activity, a very substantial part of it is directly or indirectly related to that process. Interest payments as a percent of nonfinancial gross operating income are running at approximately 31 percent, down only moderately from 35 percent during the peak in 1982 and still three times the level of a quarter century ago. Hence, the huge increase in corporate debt has essentially offset the benefits that could have occurred to corporate fixed charges from the dramatic decline in interest rates over the last 5 years.

Mr. Chairman, I have a number of other issues which I could discuss relevant to takeovers, but perhaps it would be best if I summitted my formal testimony at this point.

I raise the issue of what is an appropriate position with respect to the structure of corporate management. I conclude that corporate governance should not be required to encourage issues relevant to the environment, employees, or the general public. These are best left to statute outside the corporate sector.

I conclude that so long as takeovers do not violate third party rights they probably have great difficulty creating significant harm to the system.

The one issue which does bother me is the issue of greenmail which even though it is a voluntary arrangement between management and the takeover investors, it violates the interests of individual shareholders. As a consequence I believe that it should be banned.

[The complete prepared statement follows:]

The **Chairman**. Thank you very much, Mr. Greenspan.

Mr. Greenspan, I'm going to take less than 5 minutes I hope and other members of the committee will, too. That's our rule when we have this number of questioning members.

Mr. Greenspan, when Boone Pickens testified before this committee a year or so ago he noted that hostile takeovers were needed to root out poor management and urged the committee not to curb such takeovers lest we, "fortify management that has done a poor job."

WELL RUN COMPANIES ALSO VICTIMS OF TAKEOVERS

You say on page 3 of your testimony that the evidence does not support the contention that poorly run companies are the victims of hostile takeovers. You say, rather, that a number of well-run or improving companies have been the subject of successful takeovers.

I take it then you do not agree with the corporate raiders who justify their activities by claiming they are performing a public benefit.

Mr. **Greenspan**. I think they do in part, but as I said in my testimony, the evidence is really quite mixed. I know of a number of corporations, many of whom I have been associated with, which have been subject to takeovers and I can assure you that as best I could judge, as an outside director or as a consultant, they were run far better than the average American corporation.

One of the problems that we have Mr. Chairman, is that sometimes when corporate management does an exceptionally good job, the price of the stock does not react immediately but is perceived by a number of investors as undervalued situation. That is the judgment which has attracted them.

There are unquestionably a number of cases where management has been poor, the company has been essentially run into the ground, and corporate takeover is the only way to continue the company in a viable form.

Regrettably, that is not generally the case.

The **Chairman**. As you know, Professor Lowenstein of Columbia University, made an interesting study and a very careful study in which he showed that on the average the firms taken over for I think a 6-year period had a higher profitability—I think something like a 16 percent return on equity—compared to average run-of-the-mill corporations.

Now, as you know, there's been a sharp increase in corporate debt in the last few years. This is something I missed in the statements of most of you gentlemen and something that bothers me very much and perhaps too much. But there's been a sharp increase in corporate debt in the last few years, much of it driven by hostile takeovers. The easiest way—one natural way at least to prevent a takeover is to borrow money and buy your stock, trade equity for debt, drive up the price of your stock and make it less attractive to acquire you.

Some economists are worried that this increase in corporate debt ratio would make our economy a lot more vulnerable in a recession; and we would have more corporate bankruptcies, and the ripple effect from such failures would make the next recession deeper than it otherwise would be. It is also said that the cost of servicing increased corporate debt takes money away from other constructive activities by the corporation.

Is that a real problem, in your judgment, that we in Congress should worry about?

Mr. GREENSPAN. There's no question that the sharp rise in corporate debt, and more exactly corporate fixed charges, have made the economy more vulnerable in the event of a significant contraction. That is a problem that goes far beyond the corporate sector and I would certainly argue that it goes far beyond the question of mergers, acquisitions, and takeovers.

Only a relatively small amount of the recent huge increase the debt actually relates to corporate mergers. But Congress should be quite concerned about a major expansion in debt not only in the nonfinancial corporate sector but in the consumer sector as well. That clearly has created a higher degree of vulnerability and far less flexibility in the business sector should an unexpected contraction in economic activity occur.

The CHAIRMAN. And I think you would agree that we have not repealed the business cycle. We're going to have other recessions in the future and in such recessions some of our corporations may be more vulnerable than they otherwise would be.

Mr. GREENSPAN. Yes, sir.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Greenspan, following up on Senator Proxmire's inquiry, let me just remark that Senator Garn has been attempting to get here for quite some time. He has been stuck in a massive traffic jam and hopes to get here hopefully before you leave.

In terms of the amount of debt that has been accumulated, principally through corporate takeovers and junk bonds, to what extent would a substantial increase in interest rates or two or three quarters of negative real economic growth cause a serious financial crisis?

Mr. GREENSPAN. Senator, that's very difficult to judge. What we do know is that if we disaggregate the corporate sector we know that approximately, on average, a third of gross operating corporate income before depreciation, and interest charges, is going for interest payments. We know there is a very substantial though minority segment of the corporate system which is effectively borrowing money to pay interest. They are in a situation where they cannot absorb a significant contraction in activity.

Senator HEINZ. Is that segment related to the aftermath of takeovers and mergers and acquisitions?

Mr. GREENSPAN. I don't think so. Unquestionably, there are a number of very well-publicized occasions where companies have been pushed into that position. But that's a very small segment of the economy and that's a very small segment of this problem.

IMPACT OF 1986 TAX CODE CHANGE

Senator HEINZ. Looking to the future of mergers and takeovers, how would you assess the overall impact in light of the changes in the 1986 tax code? Will they make takeovers more or less likely;

and second, are there any other effects of the tax law that will change the way American business is run?

Mr. GREENSPAN. Well, I assume that the General Utilities Doctrine abolition will make a number of pending mergers less desirable. I think, however, that the broader issue gets down to the fundamental cause of the big surge in mergers. It is only peripherally related to the tax bill.

You can see in company after company, what happens when you impose on a structure which for generations has been put together at a very relatively low cost of capital. When the cost of capital rises it disrupts the whole structure. We are looking at the consequences of that now.

If we did not have a significant rise in the cost of capital, I doubt very much that we would be meeting here today and be as concerned as we are on this particular issue.

Senator HEINZ. Thank you very much, Mr. Greenspan.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Sanford.

Senator SANFORD. I have not seen any crusaders going around the country trying to improve management in the various corporations that have turned out to be takeover targets. I don't think that's a motivation at all.

Certainly you have pointed out some of the forces of the economy that have made takeovers more feasible, but the motivation is probably still the same and it's not necessarily to improve management.

I have also observed that appeals of all the defensive measures that have come along have been in response to the takeover movement wouldn't have been there otherwise. Some of these defense haven't worked, some of them have probably been detrimental and some of them have probably diminished efficiency.

In the interest of time, I want to ask one question. I'm not sure that this is a solution that I would support but it has seemed to me that if there were some period of time when you could not overnight use the leverage of a certain percentage of the stock ownership to force a buyout that that might be a good thing. You state that a proposal to require stock to be held for a period of time, 3 months even—you start with 6 months—would be detrimental to the market value of the shares. Why?

Mr. GREENSPAN. Largely because if you remove from the value of a share rights the value of voting rights, a share has got to be reduced in its value to a certain extent. If you can get a, say, a super majority of all shareholders willing to, forego voting rights for the people to whom they sell their shares, that's their right to do so.

My only concern is that if we are dealing with a very large minority of shareholders who are required to remove voting rights when they sell the shares to a third party. I am concerned that in effect, you are taking property from them.

Senator SANFORD. Well, I won't pursue that except to observe that most people don't buy stock because it has voting rights. They buy it because they expect a return and most shareholders don't get to vote but once a year anyhow by proxy. I question whether changes in voting rights really would affect the price of stock.

Excerpts From The Testimony Of Alan Greenspan
Before
the United States Senate
Committee on Banking, Housing and Urban Affairs
January 27, 1987

The extraordinary increase in recent years of mergers, acquisitions, and leveraged buy outs, is a response to a significant incentive: namely, the perception that the potential value of a takeover candidate could be substantially higher than the cost of acquisition. This potential profit derives mainly from the marked increase in the real cost of capital that occurred at the beginning of the decade, largely as a result of a widening structural budget deficit. While the real cost of capital, as measured either in debt or equity terms, presumably remains above normal, it has fallen a great deal recently. This suggests that the wave of mergers and acquisitions may now be cresting.

American industry generally has been structured in the context of approximately a 5% real cost of capital. Individual corporations, therefore, were structured so that the maximum use of resources would occur at that discount rate. By way of illustration, a petroleum refining-marketing complex, may have been tied to its source of crude oil in such a way that the refining-marketing facilities would be depreciated over the same time period as the depletion of the crude reserves, assuming a set rate of liftings of crude oil to supply the refineries. Assume further that the market value of the crude reserves and the refining-marketing operation (at a 5% discount rate) had maximum value at depreciation and depletion rates which spread the life of both facilities over 20 years. If the real cost of capital then rose to 7%, the refining-marketing complex already in place cannot readily alter its life expectancy, but the rate of depletion of the oil field could be changed. Maximizing the value of the oil field at the higher 7% discount rate implies a more rapid rate of depletion. Therefore, at a higher cost of capital, it makes sense to separate the crude reservoirs from the refining-marketing operation. The separate market value of the two facilities then would, of necessity, total more than the market value of the facilities when linked.

This simple example while hypothetical, nonetheless, illustrates the problem of fitting various pieces of a company so as to optimize their collective value. Since the process relates to a specific cost of capital, an alternative capital cost almost surely will not generate the same optimum return. But while the cost of capital can change rapidly, the composition of fixed assets can be altered only slowly.

One way to reestablish the maximum value use of facilities is to break apart companies, reconstituting them at their maximum use under the new cost of capital. Markets anticipate this process, gradually revaluing the individual pieces of a misaligned company at more than their value in combination. In 1983, the independently determined market value of individual television stations aggregated virtually as much as the stock market value of entire television networks. These encompassed not only television stations, but also radio stations and publishing. Oil company stocks also reflected far higher implied independent values for disengaged crude oil from refining-marketing than for the total system. So long as the companies stayed in their historical context, however, and generated incomes from that particular linked group of assets, the present value of expected future returns from those facilities for the full, but now suboptimum, life of the assets would create stock market values below their breakup costs.

The ability to take over and reconstitute these companies was, therefore, of considerable market value. As a consequence, the premiums in the stock market for control of companies began to rise very sharply. In the 1970s and earlier, the typical price premium on the critical mass of a company's shares required for control, sold at perhaps 20%-40% over the prevailing stock market values which were generated on the basis of investment in the facility as specifically constituted. In recent years, control premiums have risen to twice the market value of individual investment shares reflecting the profit in stock market values from restructuring a company. This has produced an enormous surge of takeover attempts. Any investor who could buy controlling interest in a company at less than the full control premium could profit from the difference between the acquisition price and the market value of the company under the new, restructured, set of asset relationships.

With stock prices sharply higher, and the real cost of capital declining during the past two years, premiums for control might have been expected to decline. In fact, the forces generating takeover incentives probably would have peaked, and the process might already be exhibiting significant contraction, were it not for the extraordinary expansion in financings coming from so-called "junk bonds". This has extended the potential profit on takeovers and restructuring, by measuring the number of potential corporate acquirers.

It's long been an oddity of corporate finance that risk premiums imposed on lower quality, higher yielding, corporate long-term obligations, currently dubbed junk-bonds, have in recent years appeared to be larger than actual losses seemed to suggest was appropriate. As a consequence, issuers of such bonds, were relatively few in number until recently. A decade ago less than 5% of public corporate bonds outstanding were low-grade bonds. The market began to change radically a few years ago as investors, confronted with falling interest rates, began to look toward higher yielding lower grade bonds to maintain their interest incomes. As yield spreads came closer to actual loss experience, lower grade credits rapidly increased their share of total outstanding corporate debt to almost 15%.

Junk-bonds eventually should rise to their appropriate share of corporate long-term obligations. At that point, the rate of increase in the quantity of such bonds outstanding should slow fairly dramatically. That, of course, will mean a fairly significant decline in the net new issues of junk-bonds. Hence, the current junk-bond explosion must be viewed as a one-shot market adjustment reflecting previous undervaluation. As higher yielding, higher risk obligations find their new niche in the market, their growth is likely to be more in line with overall corporate debt than with the frenetic pace of recent years. Since they will continue to be available to expanding corporations which are more risk prone, this will increase the overall risk of bond default.

Though the takeover, merger, acquisition frenzy probably is in the process of cresting, and is likely to decline as a result of the sharp increase in stock prices, in its wake, the process has left a significant deterioration of the corporate sector. As a consequence of mergers, acquisitions, leveraged buy outs, and corporate stock repurchase programs, the net liquidation of nonfinancial corporate equities has approximated an incredible $230 billion since the beginning of 1984. As the asset side of the corporate balance sheet has continued to expand, the equity liquidation has, in effect, been a substitution of debt. While all of the debt accumulation has not reflected takeover and merger activity, a very substantial part of it is directly or indirectly related to that process. Interest payments as a percent of nonfinancial gross operating income currently are running at approximately 31%, down only moderately from 35% during the peak in 1982 and still three times the level of a quarter century ago. Hence, the huge increase in corporate debt has essentially offset the benefits that could have occurred to corporate fixed charges from the dramatic decline in interest rates over the last five years.

While some takeovers may have forced moribund management into a more effective use of corporate assets, it is difficult to make the case that the markets are functioning in the manner which theory suggests they should. One would assume that the least well run companies generally were subject to takeovers. Cursory evidence of particular takeover targets suggests that the evidence is mixed, at best. A number of rather well run or improving companies have been the subject of successful takeovers merely because their stock prices have not yet fully reflected their improved status.

Of greater importance is the question whether something is fundamentally wrong with a structure of corporate governance that is creating a form of behavior that undercuts the optimum use of capital. In principal, corporations are run for the benefit of their shareholders, within the context of laws that are designed to protect the rights of third parties. Those third party protections, whether for employees, the community, or the environment, are appropriately left to statute. They should not be obligations of corporate management. Such goals might be in conflict with the primary purpose of maximizing the value of the corporation for its shareholders. Endeavoring to run a business through the reconciliation of conflicting purposes leads to the type of inefficiencies nationalized industries so clearly personify.

All takeovers are, of necessity, voluntary in the sense that investors induce shareholders to sell their shares. Therefore, any alteration in the law or its associated regulations must be based on the presumption that the voluntary agreement between the two consenting parties currently violates the rights of third parties. So-called "Green mail" is a third party rights violation. It is essentially an agreement between management and one or more shareholders to buy back their stock at a price not available to the remaining shareholders. Since it is the other shareholders' resources which are being employed to buy back a single shareholder's stock, there is a clear violation of third party, i.e. other shareholders' rights.

Changes in voting rights on existing shares, another discussed change in corporate governance, raises more difficult questions. There is nothing to prevent the existing body of shareholders from unanimously agreeing that henceforth all voting rights on shares of that corporation would be rescinded for holders until the shares were held for a minimum of 6 months, 12 months, 2 years, or whatever. That process would lower the market value of the individual shares of the company. Should the vote to do this be less than unanimous, those shareholders who do not choose to go along would suffer an involuntary reduction in the value of their shares. Hence, it is difficult to justify such actions.

The requirement that all shareholders obtain the same value for their shares in a takeover seems consistent with existing protections of property rights; some so-called "poison pill" activities do not.

It should not come as a great surprise that the vast number of financial transactions currently associated with the restructuring of American Industry are creating very large revenues and profit for the investment banking industry. The sharp rise in the real cost of capital which followed the deterioration of our federal budget outlook has created great pressures to restructure American industry in line with the new higher levels of capital cost. (Pressures to compete internationally also have been a key factor.) This significant above normal rate of return for financial services is of necessity, a short-term phenomenon. It will fade if the pending sharp reduction in the federal budget deficit brings down the cost of capital and dramatically reduces the number of transactions associated with trying to cope with it. Alternatively, the restructuring required to adjust to the new higher cost of capital will be completed, and the abnormal pressure for investment banking services will also decline. The legal prohibition on large well financed commercial banking institutions to offer services comparable with those of investment banking institutions also may have had the effect of restraining supply during periods of intense demand.

It's important however, to recognize that the current abnormalities in investment banking and mergers and acquisitions are temporary. They reflect the markets' endeavors to readjust to abnormalities in the economy's cost of capital, the result not of private, but of government, actions.

In summary, restructuring some of the elements of corporate governance which undercut the rights of shareholders makes sense. Endeavors to alter some of the broad relationships within the financial community which have served us well and are currently temporarily out of alignment does not.

Mr. **Greenspan**. Well, I grant you, Senator, I would not make a big issue of it. It has to have only one effect. How significant that is, is, I grant you, not easy to determine.

I am also not certain that that particular restriction will significantly affect merger activity. That's another issue altogether.

Senator **Sanford**. Thank you.

The **Chairman**. Mr. Greenspan, you only have a few minutes left, so I hope we can get the next five questioners in order. Senator D'Amato.

Senator **D'Amato**. Mr. Chairman, I would simply ask Mr. Greenspan to comment on the statement that the Deputy Secretary of the Treasury Richard Darman made. Richard Darman has argued that "entrenched corpocricy exists in American business and is causing a decline in the competitiveness of American industry." According to Mr. Darman: "hostile takeovers are a response to the need to discipline entrenched management and hold it accountable to the marketplace."

Would you make an assessment of Mr. Darman's remarks.

Mr. **Greenspan**. Mr. Darman is a good friend of mine and I usually agree with him most of the time. There are obvious problems in any bureaucratic structure. If one looks hard enough one can always infer entrenched bureaucracies which are undercutting the structure of the system.

I don't think that currently the problem is any greater or less than it's ever been.

Senator **D'Amato**. Mr. Chairman, I recognize the time constraints.

The **Chairman**. Thank you very much, Senator D'Amato.

Senator Shelby.

Senator **Shelby**. I'll be brief, Mr. Chairman.

HIGH YIELD BONDS

Mr. Greenspan, do high yield bonds in certain cases play a positive role in our economy?

Mr. **Greenspan**. Indeed they do, Senator.

Senator **Shelby**. How?

Mr. **Greenspan**. They help finance corporations which have the capability of issuing bonds but only bonds of less than investment grade. They are usually companies which have difficulty borrowing in general.

Senator **Shelby**. Are they generally smaller companies?

Mr. **Greenspan**. Not necessarily. Some of them are relatively large. So long as investors are aware of the fact that these are low quality bonds and so long as other aspects of the issuance are legal and appropriate, they serve a useful purpose, and they have removed a lot of borrowers from the banking system. Net on balance that may be good rather than bad.

Senator **Shelby**. Thank you.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Shelby.

Senator Garn.

STATEMENT OF SENATOR JAKE GARN

Senator GARN. Thank you, Mr. Chairman.

Alan, I'm pleased that you are here today and I would apologize for being late but I would prefer that Mayor Barry apologize for my lateness.

[Applause.]

Senator GARN. But because of the time constraints, I will not ask you any questions at this time.

This morning the committee continues its examination of the issues related to mergers and acquisitions, and their role in the U.S. capital markets and their effect on U.S. competitiveness in world markets. The committee's examination is undertaken at a time when merger and acquisition activity, and what some regard to be related issues, such as insider trading and growing corporate debt, have been brought up from the business pages of the daily newspapers to the front pages—the focus of the Nation's public attention. Some people come into this national debate with the preconceived notion that something has to be done to stop what they regard to be an unprecendented merger wave. These hearings afford us an opportunity to determine whether the current regulatory framework is deficient and whether the various regulatory cures being discussed may in fact create more problems than they solve.

There are many critical issues that need to be examined in detail. These issues include two-tiered and partial tender offers, greenmail payments, golden parachute compensation packages given to corporate management sometimes even in the midst of takeovers, and the effect of merger and acquisition financing on credit availability in the United States. I anticipate testimony from a long list of witnesses from the academic coummunity, the investment banking community, and the corporate community. I hope that today's witnesses and those who follow will provide us with hard evidence on all the details and nuances of takeover activity.

I look forward to the testimony of this morning's witnesses because, to a certain extent, their comments on the critical issues involved in the merger and acquisition debate will impact on the direction that our corporations take in responding to the global competition.

The CHAIRMAN. Thank you very, very much, Senator Garn.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

When time is a little less scarce, I want to make a couple of opening comments myself.

But let me go right to your statement, Mr. Greenspan. You make a somewhat cryptic comment where you say,

> Some takeovers may have forced moribund management into a more effective use of corporate assets. It is difficult to make the case that the markets are functioning in the manner in which theory suggests they should,

and then you go on to elaborate some on that.

MARKET FUNCTIONING PROCESS

I would like to ask you just directly, is it your sense that the markets in some manner are not functioning as they should and, if so, can you put your finger on that problem as you see it?

Mr. GREENSPAN. The reason it's a cryptic remark, Senator, is that I'm bothered by the slowness of the adjustment process. We are in effect seeing the effects of changing the fundamental cost of capital in the system and are creating very significant though temporary misalignments. The markets essentially react to that in a somewhat similar manner that the human body reacts against viruses. And the consequence of that is to create a number of unusual things, such as temporary but very large above-market rates of return for certain investment banking type of operations. It creates very large changes in the market values of some securities.

I am bothered by the sense that those adjustments are happening far more slowly than theory would tell us they should. In other words, we should be getting more competition adjusting the system. The system is working, but I don't think we fully understand how significant the federal budget deficit problem reflects real interest rates. It's got very profound effects on how American industry structures itself. That process is working, but it is working far less effectively and I suspect far less slowly than the textbook theory would tend to suggest.

Senator RIEGLE. Then my question would be, if we're in that kind of adjustment process and it's happening very slowly and that's creating other difficulties, are there things that you see specifically that perhaps we should do during this stretched out adjustment process or something to speed up the adjustment process?

I'm wondering, from your vantage point, do you see something that needs to be done to try to deal with this problem as you see it?

Mr. GREENSPAN. Senator, the problem is that I'm not at all convinced that the real cost of capital should stay where it is and that we should adjust to that because, without getting into the theoretical implications the higher the cost of capital in real terms, the less efficient the system. We are adjusting to that less efficient system and may find that the cost of capital will be at some point be restored to its old appropriate lower level. That means we have to go through the whole process in reverse in order to return to the type of structure which we had.

I suspect that there is little that the Congress can do. If certain areas were identified for legislation, my suspicion is that by the time it was in place it would probably no longer be appropriate.

I've thought about this a great deal. With the exception of very minor technical changes in corporate governance, I find it difficult to find other than macroeconomic policies being useful in this respect.

Senator RIEGLE. Thank you.

The CHAIRMAN. Thank you, Senator Riegle.

Senator Metzenbaum.

Senator METZENBAUM. Very briefly, I understand, Mr. Greenspan, you would ban greenmail, right?

Mr. GREENSPAN. Yes, sir.

Senator METZENBAUM. And you would ban two-tiered offers?

Mr. **GREENSPAN**. Probably, yes.

Senator **METZENBAUM**. And you would restrict poison pills?

Mr. **GREENSPAN**. Yes, sir.

Senator **METZENBAUM**. And you would limit or severely restrict changes in voting rights of shares that are made solely for the purpose of protecting management?

Mr. **GREENSPAN**. It depends. If you're asking me do I object to the protection of management in the context which you raise the question, yes, I do. But I would prefer not to answer very explicitly until I see exactly what type of regulation you have in mind.

Senator **METZENBAUM**. I thank you.

I thank you, Mr. Chairman.

The **CHAIRMAN**. Well, thank you very, very much.

Thank you, Dr. Greenspan. We're delighted to have you, as always. You are a most helpful witness and you're excused now. I understand you have a plane to catch and you're in good shape for it.

I understand the other witnesses—well, I would like to apologize to the other witnesses. I probably made a mistake in arranging this. What we should have done is let Mr. Greenspan testify and then let him go. We've held you up and I apologize and I apologize also to the following witnesses who are going to appear. We have such distinguished people here, it's probably costing the country thousands of dollars in income taxes that you would be earning and paying.

Mr. **GREENSPAN**. Mr. Chairman, may I add $100 or $200 to that by expressing my appreciation and regret that I have created a disturbance here.

The **CHAIRMAN**. Thank you, sir.

Mr. Brady, go right ahead, sir. We are delighted to have you.

STATEMENT OF NICHOLAS F. BRADY, CHAIRMAN, DILLON, READ & CO., INC., NEW YORK, NY

Mr. **BRADY**. Thank you, Mr. Chairman.

I would like to thank the committee for this opportunity to present my views on the procedures, practices, and financing of hostile takeovers as well as the effects these activities have on our economy and international competitiveness.

I applaud the committee's willingness to confront these difficult and complex issues. In this regard, let me suggest two principles that have helped me guide my way through the securities laws and may I be as bold as to say that perhaps they would help the Banking Committee as they contemplate reform in these areas.

These two principles are: One continue the Williams Act philosophy of favoring neither bidder nor target and, two, equally important, keep an eye out for the small shareholder.

These hearings are particularly timely in light of the insider trading scandal that is unfolding in Wall Street. Insider trading is illegal behavior. There are existing laws which prohibit insider trading and these laws need to be enforced vigorously.

There also needs to be clarification of exactly what conduct is to be prohibited by the concept of insider trading. Then new laws need to be written or existing laws modified to prohibit such conduct.

However, we should not confuse insider trading with the regulatory framework that governs the actions of bidders, targets, management, and other participants in takeovers. That regulatory framework is basically sound and has done, by and large, its job, although I do have some substantive legislative changes to suggest.

OBSERVATIONS ON HOSTILE TAKEOVERS

The committee has my written statement and rather than repeat it in full, I think it may be more helpful to offer a few observations about the policy issues that confront this committee in examining hostile takeovers and about the current environment in Wall Street, and then proceed directly to my recommendations for legislative action.

I am not here today to tell you that hostile takeovers or friendly ones for that matter are an unmixed blessing. They have given rise to a number of troubling activities, including greenmail, golden parachutes, and profits on the part of raiders, arbitrageurs, and bankers that appear to be out of proportion.

In addition, one hears the disturbing arguments that the threat of a hostile takeover has focused too much of management's attention on short-term profits and undermined our international competitiveness.

Let me speak directly to these points. Perhaps due to the publicity that surrounds them, there may be a tendency to single out hostile as opposed to friendly takeovers as a subject for regulatory reform. In my view, the distinction between hostile and friendly takeovers seems to have little bearing on the questions of economic efficiency and international competitiveness.

Many friendly mergers begin on a hostile footing and many transactions originally conceived as friendly can turn hostile in a hurry.

The real question before us is whether the business judgment surrounding a particular merger or acquisition should rest with government regulation, either Federal or State.

On the question of whether the threat of hostile takeovers focuses the attention of management to an excessive degree on short-term profits, I find the evidence to be very troublesome. Common sense would suggest that companies will be reluctant to invest heavily in research and development and run the risk of lower short-term earnings and a lower stock price, thus providing the perfect opening for a raider.

On the other hand, the market has shown the ability to evaluate and reward investment in research and development. The drug and biotechnology industries are cases in point.

In all honesty, it really seems to me that concentration on short-term profits is just as directly related to the institutionalization of our stock markets—illustrated by the quarterly performance derbies between money managers—as it is to hostile takeover activity.

At any rate, it is my opinion that the securities laws are the wrong place to address the question of investment in research and development. We can do that elsewhere.

With regard to the issue of international competitiveness, I am not persuaded by those who cite the example of our principal rivals, the Germans and the Japanese, who do not currently engage in the hostile takeover activity to the extent that we do. I simply can't make the situations which exist in our automobile and steel industries, where in the case of the automobile industry there have been no takeovers, hostile or friendly; and in the steel industry very little—I can't make that jibe with the fact that they are the principal focus of our lack of competitiveness. There is no correlation at all between the takeover activity, of which there isn't any in these areas, and our lack of competitiveness. That has a lot to do with a lot of other things we have all discussed such as maybe too much corporate bureaucracy, high labor rates, and the like.

At any rate, we have had other periods of high takeover activity in this country and yet American industrial competitiveness for the main part has endured. I'm not persuaded that takeovers have a great deal to do with it.

With that background, perhaps a few observations on what is going on in Wall Street would be appropriate. I testified 20 months ago before the Senate Finance Committee about the overheated financial environment, the unsoundness of junk bond takeover financing, and I agree with Senator Sanford, the one-dimensional philosophy that it represents; and, of course, another problem is the consequent leveraging of our economy.

$75 BILLION WITHDRAWN FROM THE SYSTEM IN 2 YEARS

Consider that in each of the past 2 years, over $75 billion in equity has been withdrawn from the system. Chairman Volcker and Chairman Shad have both written about this disturbing trend and I share their concerns.

Many have also sensed that there was something tilted about a game in which the same group of raiders, arbitrageurs, and bankers attack one company after another, reaping profits without ever seeming to take risks or losses. Something was just not right.

Recently, these suspicions have been aggravated by the largest insider trading scandal in our financial history. Those involved have violated a fundamental trust and they have done great harm. However, I would again urge this committee to draw the important distinction between insider trading activities and the basic laws that govern our regulatory framework in which takeovers occur.

Insider trading is already illegal. To this end, legislative action is needed to clarify what constitutes insider trading as well as to enhance the ability of the SEC to enforce the laws that are already on the books.

As far as the broader regulatory framework and the possibility of landmark legislation are concerned, this is a personal opinion based on 30 years in the business, but I truly believe it ain't broke so don't fix it.

I do suggest that certain important changes in our securities laws be enacted and I suggested at the outset all of these proposed changes have a common philosophy which Congress in its wisdom has observed over the years. Neither favor the bidder nor the target and keep an eye out for the small shareholder who frequently is the forgotten person in this debate. This is essentially the philosophy that Congress has already adopted in enacting the Williams Act and it's eminently sound.

As far as the investment banking industry is concerned, the problem of excess will undoubtedly find its usual solution. Our industry has traditionally been a cyclical one and conditions in 1987 are very reminiscent of those prevailing in 1968 just before the last big turndown—a boiling stock market, high profits in Wall Street, and a takeover binge fueled by the activities of the go-go mutual funds which I would suggest to those students of financial history are almost exactly parallel to the work of the arbitrageurs that's going on today.

Now getting to recommendation, I would like to recommend seven specific legislative actions.

First, the SEC's ability to police insider trading must be strengthened. The Commission simply needs more cops on the beat. I applaud the administration's decision to request a 26-percent increase for fiscal 1988 in the SEC's budget and I urge that the Commission be encouraged to devote the lion's share of these new resources to enforcement.

The CHAIRMAN. Mr. Brady, I'm embarrassed. Your statement is a terrific statement and your recommendations are the best part of it. You are just coming to them. Unfortunately, your time is up. Could you just give us one sentence on each one? We have the text in front of us.

Mr. BRADY. You bet. I think that the second thing I believe, after the SEC budget, is that it's important to have a clarification of what constitutes insider trading. Mr. Chairman, may I beg your indulgence on one point? I think that we should closely examine the situation where investment bankers by somehow imparting insider information or information to the arbitrage community have laid a launching platform for many of the takeovers that we have seen recently and I think the definition of insider trading ought to be expanded to include that activity.

Third, on section 13(d) which you all have commented on, I think a 10-day period is too long and I would shorten it to 1 day. I see no reason to make it 2 days. One day will get the job done just as well. All the law firms have offices here in Washington and, believe me, if you pass the law that way it will get done.

Fourth, I believe that we should outlaw the creeping tender and that anyone increasing his ownership to over 20 percent either by 1, 10, or 80 percent should do so by means of a tender.

Fifth, on the issue of greenmail, this is a difficult issue. It's complicated, but my solution to it would be to make it mandatory that before anybody can engage in greenmail that they have a very detailed exposition of what they are doing to their shareholders. I wouldn't ban it. I would just make everybody say exactly what they are going to do before they do it.

Sixth, is a practice known as sweeping the street and several times over the past year bidders have withdrawn this tender offer and just bought all the stock in the street. I would have a cooling-off period there of perhaps 20 days so that the street couldn't be swept without getting a little time to think it over.

Last, I think you ought to do some housekeeping while you're at it and make the Williams Act and Hart-Scott-Rodino Act—put them in sync and I think if you did that this would get rid of the partnerships and the kind of things that we've seen that are ways around this law.

I think if you do these things, Mr. Chairman, you don't need a landmark legislation. You will see a leveling of the playing field on the activities side.

[The complete prepared statement follows:]

Revised

STATEMENT OF NICHOLAS F. BRADY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

I. Introduction

My name is Nicholas F. Brady, and I am Chairman of the investment banking firm of Dillon Read. I have been active in business and in Wall Street for over 30 years, and in the course of that time I have advised and participated in a number of takeovers and mergers, both hostile and friendly.

I would like to thank the Committee for this opportunity to present my views on the procedures, practices and financing of hostile takeovers, as well as the effects these activities have on the economy and on our international competitiveness. I applaud the Committee's willingness to confront these difficult and complex issues. In this regard, let me suggest two principles that can guide the Banking Committee through the complexities that surround the securities laws: continue the Williams Act's philosophy of favoring neither bidder nor target, and keep an eye out for the small shareholder.

These hearings are particularly timely in light of the insider trading scandal that is unfolding in Wall Street. Insider trading is illegal behavior. There are existing laws which prohibit insider trading and these laws need to be enforced vigorously. There also needs to be clarification of exactly what conduct is to be prohibited by the concept of insider trading. Then new laws need to be written or existing laws modified to prohibit such conduct. However, we should not confuse insider trading with the regulatory framework that governs the actions of bidders, targets, management and other participants in takeovers. That regulatory framework is basically sound and has by and large done its job, although I have some substantive legislative changes in that area to suggest. But first, I think it would be helpful to look briefly at the nature of our system, and to discuss some of the basic policy issues that confront this Committee.

II. Background and Comments

It hardly needs stating that the American system of democratic capitalism has produced, throughout most of our history, a remarkable and sustained level of prosperity. This form of economic endeavor has produced a standard of living that is among the very highest in the world. Under our system as it has evolved, decisions such as the allocation of capital and the establishment of prices are made primarily in the private sector.

Our capital markets are the most advanced, the most liquid, the most democratic, and still the most honest in the world. The ability of capital to flow freely to opportunities for profit has been a crucial ingredient in our success. To this end, the goal of the investment banking industry is to act as a conduit through which capital flows to useful projects.

The fundamental form of large business organization under our system is the publicly owned corporation, which emerged in its modern form around the turn of this century. Public corporations share certain common characteristics that are relevant to this hearing. They are owned by an estimated 47 million shareholders across the country. In theory, at least, the corporation is a democratic institution, in that the shareholders vote annually to elect a board of directors to oversee the work of the hired managers. Our economic success is in no small part due to the success of the corporation in balancing the interests of its various constituencies -- employees, consumers, shareholders and the communities it serves.

Often in the business world there arises a conflict between the various constituencies of the corporation. For example, it may be in the shareholders' interest that workers who are not contributing adequately to the firm's output be encouraged to find work elsewhere. And in the case of a hostile or friendly takeover, the conflict can be a particularly direct one: the shareholders' interest in maximizing the value of their investment can be at odds with the interests of both management and the employees in keeping their jobs.

When this apparent conflict has arisen, Congress has generally resisted the temptation to take sides. And I would argue that we choose one side over another only at very real risk. Imperfect as it may seem, I question whether there is a system that will produce better results in the long run than one that leaves the fundamental decisions in the allocation of capital and jobs -- such as take place in a merger -- to the private sector.

I am not here to deny that there are many aspects of our system that are mixed blessings. Take, for example, the corporate "restructurings" that have been taking place across America over the past few years. Business theorists and the stock market have generally lauded companies for divesting underperforming or non-essential business units in order to concentrate on what they do best. Along with this trend, there has also been a noticeable "leaning down" of the American corporation, involving the reallocation of underemployed assets, and the freeing of corporate America from the dead hand of bureaucracy. While this trend is generally seen as a rejuvenating, even exhilarating phenomenon, there is no denying the real cost in human suffering when old plants are shut down and workers -- both blue and white collar -- must find work elsewhere. The concern and support shown by both the federal and State governments for those affected -- including unemployment compensation, job training and similar programs -- are a critical part of our society.

Let me speak directly to several of the reasons that are advanced for putting a stop to takeovers, particularly hostile ones. These arguments hold that "hostile" takeovers should be viewed differently from "friendly" ones; that the threat of hostile takeovers focuses management's attention on the short-term; and that takeovers are undermining our international competitiveness.

Perhaps due to the publicity that surrounds them, there may be a tendency to single out "hostile", as opposed to "friendly", takeovers as a subject for regulatory reform. As is true with any decision, a particular merger may ultimately be proved wise or unwise. However, there is no reason to suppose that the "wisdom" of a particular merger is a function of whether it is originally conceived with "friendly" or "hostile" intent. In fact, the distinction between "hostile" and "friendly" takeovers seems to me to have little bearing on the questions of economic efficiency and international competitiveness. Many "friendly" mergers begin on a "hostile" footing, and many transactions originally conceived as friendly can turn hostile in a hurry. The real question before us today is whether the business judgment surrounding a particular merger or acquisition should rest with government regulation, either federal or state.

Another important question is whether the threat of hostile takeovers focuses the attention of management to an excessive degree on short-term profits. I find the evidence on this question to be troublesome. Common sense suggests that some companies will be reluctant to invest heavily in research and development, and run the risk of lower short-run earnings and a lower stock price, thus providing the perfect opening for a raider. On the other hand, the market has shown the ability to evaluate and reward investment in research and development. The drug and biotechnology industries are cases in point. It also seems to me that concentration on short-term profits is just as directly linked to the institutionalization of our stock markets -- illustrated by the quarterly performance derbies between money management institutions -- as it is to hostile takeovers. At any rate, it is my opinion that the securities laws are the wrong place to address the question of investment in research and development.

With regard to the issue of international competitiveness, I am not persuaded by those who cite the example of our principal rivals -- the Germans and Japanese -- who do not currently engage in the hostile takeover to the extent that we do. I believe that our system -- indeed our nation -- is fundamentally different. We are a nation of immigrants from all corners of the globe. We lack the social cohesion that is an important asset of our principal rivals. But neither do they have our remarkable tradition of entrepreneurship. No other nation in the world celebrates or rewards its entrepreneurs as we do. The result is that, despite the apparent disorder that marks our society, we are still the world's leading innovators in science, the arts and politics. We have had other periods of high takeover activity in this country, and yet American industrial competitiveness was not harmed. I am not persuaded that takeovers have a great deal to do with international competitiveness, and I do not believe that we should attack the problems of international competitiveness and technological sufficiency through amendments to the securities laws.

The automobile and steel industries are interesting cases in point. To me, they represent the most disturbing examples of our difficulties in meeting foreign competition. Yet to my knowledge there have been no hostile takeovers in the automobile industry, and only a few scattered instances of hostile activity in steel. The truth is that our competitive difficulties in these two crucial industries have nothing at all to do with hostile takeovers.

Within our system, I believe that the concerns that Congress has already identified in regulating takeovers are the proper ones:

(i) First, that the process should favor neither bidders nor targets;

(ii) Second, that the regulatory framework should have no effect on either the decision to allocate capital to a merger, or the form that a merger should take; and

(iii) Third, that shareholders should have full disclosure of all material information, as well as the time to consider and act upon that information.

III. Observations on the Current Environment

With that background, perhaps a few brief observations on what is going on in Wall Street today would be appropriate. I testified twenty months ago before the Senate Finance Committee about the overheated financial environment, the unsoundness of junk bond takeover financing and the one-dimensional philosophy that it represents. For example, in each of the past two years, over $75 billion in equity has been withdrawn from the system. Chairman Volcker of the Federal Reserve Board and Chairman Shad of the SEC have written of this disturbing trend. I share their concerns.

Many have also sensed that there was something tilted about a game in which the same group of raiders, arbitrageurs and bankers attacked one company after another, reaping profits without ever seeming to take any risks or losses. Something was just not right.

The CHAIRMAN. Thank you, Mr. Brady.
Mr. Rohatyn.

STATEMENT OF FELIX G. ROHATYN, SENIOR PARTNER, LAZARD FRERES & CO., NEW YORK, NY

Mr. ROHATYN. Thank you, Mr. Chairman. It's a pleasure to testify. You have my full statement and I will try to summarize it as quickly as possible.

As the revelations of illegality and excess in the financial community begin to be exposed, we, in the financial community, have to face a difficult truth. There is a cancer threatening our industry. The cancer is called greed.

It is driven by a general climate of feverous speculation and its most deeply disturbing aspect so far has been the Boesky affair.

The need for productive investment in this country, together with the risks created by the level of existing speculation, make it more important than ever that the integrity of the markets be assured and that capital be used to build and not to speculate. This is the framework in which the current issues should be considered.

The questions raised by recent events should be examined in two contexts: Illegal activity on the one hand, and the implications to the economy of the present level of takeover activity on the other.

INTEGRITY OF THE INDUSTRY

With respect to the former, other witnesses will comment on enforcement and the possible need to change. However, there is a broader issue involved here, namely that of the ethics of a profession where integrity has to be fundamental.

The explosive growth in financial services, and the huge rewards related thereto, have caused obvious strains on the ability to maintain relatively old-fashioned standards and traditions while adjusting to the pressures of the new deregulated environment and the technologies which allow endless development of new products.

An industry which traditionally provided independent financial advice and distributed securities on behalf of its clients has turned into a business creating and selling new products and relying more and more on the trading of securities. This is the age of the financial samurai. The same is true of many law firms, and the behavior of financial institutions is mostly geared to short-term results. Too much money is coming together with too many young people, with little or no institutional memory for tradition, under enormous pressures to perform and under the glare of Hollywood-like publicity. Insider trading is but one manifestation of this cancer. No firm, not even my own, is immune from it.

It is against this background that we should look at the present situation. The issues involved here are threefold: the integrity of the securities markets; the safety of our financial institutions; and the use of capital for growth.

Present takeover abuses fall into three general categories and I would say that I agree completely with Nick Brady and differentiate between hostile and friendly takeovers. I differentiate between takeovers have to be fair and they have to be properly financed.

The three categories are: Unequal treatment of shareholders as part of offensive or defensive corporate actions; unsound financial structures as a result of excessive leverage; and the destabilizing impact of large- scale arbitrage and other short-term trading activities as an integral part of mergers and takeovers.

A brief look at each. The basic concept of our securities laws has been full disclosure, nonmanipulation, and equal treatment of all shareholders. Current techniques and legal trends undercut these concepts.

Two-tier takeover bids favor professional traders. Bids that are made subject to financing, in many cases directly or indirectly financed by junk bonds, permit the bidder to manipulate the markets without committing himself to purchase. The resulting activity by arbitrageurs and traders create speculative accumulations which put the company into play.

Because of these tactics, defensive maneuvers have been devised that are equally objectionable to shareholders—lockups, poison pills of one kind or another, repurchase of stock, all of them designed to enable managements and boards of directors to interpose themselves between the share- holders and takeover bids.

As a result of this activity, financial structures are seriously eroded. Some of the largest takeovers in recent years were brought about as a result of raids, financed by junk bonds. Some of the targets were acquired by third parties. A large part of the oil industry has been reorganized as a result. The deterioration in their combined balance sheets has been dramatic. Far from being a healthy restructuring, the oil companies involved are cutting exploration sharply, a practice our country will pay for dearly when the next energy crisis occurs.

The risk in this type of operation is twofold. First, in the security of the paper. With the servicing of very high levels of debt, at rates of interest in excess of most targets return on investment, requires significant asset dispositions which may not always be possible or desirable. The alternative to a breakup requires significantly improved cash flow. This requires cutbacks in research and development, capital spending, and usually significant reductions in employment. It may cause some companies to be more competitive. It may also require sacrificing the future.

The second element of risk is liquidity. In many instances, no large-scale, liquid public market exists in these securities and purchases and sales are handled through private transactions.

To protect themselves against this type of takeover, companies have begun large-scale restructurings of their own whereby they assume significant amounts of new debt in order to shrink their equity and increase the price of their stocks. In addition, some of these companies have paid vast amounts of greenmail. Excessive debt-to-equity ratios are the result.

FINANCING BY JUNK BONDS

Last is the market speculation which has become an integral part of the process. Very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools are financed by junk bonds. Equally large pools of money are in the hands of raiders, similarly financed. This creates a potentially interlocking set of relationships which has as its basic purpose the destabilization of a large corporation and its subsequent sale or breakup. It creates, at the very least, the appearance, if not the reality, of professional traders with inside information, in collaboration with raiders and junk bond buyers, deliberately driving companies to merge or liquidate.

An important and related factor is the behavior of institutional investors. Between $75 and $100 billion of junk bonds have been placed over the last 5 or 6 years. The cornerstone of junk bond takeovers is the willingness of large financial institutions to acquire this paper in vast amounts in order to show performance.

In summary, what does all this add up to?

At a time when we are trying to encourage long-term investment, this activity encourages speculation and short-term trading.

At a time when we are trying to strengthen our important industries to make them more competitive, this activity weakens many of our companies by replacing their equity with high-cost debt.

At a time when many financial institutions are under considerable pressure, this activity causes some of the weakest sectors to acquire large amounts of risky and possibly illiquid paper to show performance.

At a time when we need to continue attracting capital from all over the world, our securities markets appear to be more and more under the control of professionals and insiders.

As a result, I believe that Congress should look at legislative or regulatory actions that should cover some of the following:

I will summarize these. In terms of junk bonds, I think we ought to look at limiting the amount of below-investment grade paper which can be carried by federally or State insured institutions.

We ought to require a higher standard of care and prudence from directors, officers, or trustees investing in this type of paper if they are to be protected by indemnification provisions. We ought to make clear that achieving the highest short-term investment returns is not the main fiduciary obligation.

We ought to look at tax deductibility of interest by highly leveraged companies.

We ought to review whether disclosure is a sufficient standard to qualify securities for registration.

On takeovers and tender offers, we should require 100 percent financing commitments before allowing a tender offer to commence; we should lengthen the tender offer period to 60 days; and we should require a one-price, 100 percent offer for any buyer wishing to acquire more than 20 percent of another company.

The other suggestions I have listed, Senator, and I don't need to go into them. If we, however, reduce the abuses on the offense, we should consider the following in order to protect the shareholders: We should outlaw all forms of greenmail unless possibly with a shareholder vote. We should reestablish and look at the principle of one-share-one vote. We should eliminate any form of poison pills. We should require shareholder vote on any bona fide offer for 100 percent of a company, or on major restructuring proposals. We should eliminate crown jewel options, shark repellents, and all other defensive stratagems designed to discourage a bona fide bidder. We should override State takeover statutes which provide management and directors with almost unlimited license to turn away bona fide bidders and entrench themselves.

I am obviously not suggesting that all of these should be adopted, but they are all elements of the various issues involved here. The objective of any legislative or regulatory approach should be to create a level playing field as to bidders and targets, and return many major corporate decisions into the hands of investment-oriented shareholders.

There are always arguments against any changes. The political power of the junk bond lobby was in evidence last year when Federal Reserve Board Chairman Paul Volcker barely won the right to effect a minor change in the margin rules against fierce opposition. Both in the Senate and the House, arguments for legislative change were brushed aside. However, the integrity of our securities markets and the soundness of our financial institutions are vital national assets. They are being eroded today.

The securities industry is and has been heavily regulated since the 1930's. It has operated successfully and comfortably in a highly regulated environment. The notion that additional legislation or regulation would interfere with a totally free market is a myth.

I hope that this time financial industry leaders will cooperate with the Congress to help shape rational laws and rules to reform the system. If they do, our financial market will emerge stronger and cleaner from its inevitable torment. If they do not, the resulting legislation may be so punitive as to result in detriment to all.

Thank you, Mr. Chairman.

[Complete prepared statement follows:]

Recently, these suspicions have been aggravated by the biggest insider trading scandal in our financial history. Those involved have violated a fundamental trust, and done great harm.

However, I would again urge the Committee to draw the important distinction between insider trading activities and the basic regulatory framework in which takeovers occur. Insider trading is already illegal. Legislative action is needed to clarify what constitutes insider trading, as well as to enhance the ability of the SEC to enforce the laws that are already on the books.

As far as the broader regulatory framework and the possibility of landmark legislation are concerned, I believe that "it ain't broke, so don't fix it". However, I am going to suggest that certain important changes in our securities law be enacted. As I said at the outset, all of these proposed changes have a common philosophy: favor neither bidder nor target, and keep an eye out for the small shareholder, who frequently is the forgotten person in this debate.

As far as the investment banking industry is concerned, the problem of excess will no doubt find its usual solution. Our industry has traditionally been a cyclical one, and conditions in 1987 are reminiscent of those prevailing in 1968, just before the last big downturn: a boiling stock market, high profits in Wall Street, and a takeover binge fueled by the activities of "go-go mutual funds".

IV. Recommendations

I would like to recommend seven specific legislative actions that I believe would represent an important contribution by this Committee:

1) First, the SEC's ability to police insider trading must be strengthened. The Commission simply needs more cops with greater resources on the beat. Wall Street has expanded rapidly in recent years. Enormous investments in new technology have been made, and transactions are now recorded in minutes between parties in all corners of the globe. Despite its Herculean efforts, the SEC cannot keep up. I applaud the Administration's decision to request a 26% increase for fiscal 1988 in the SEC's budget, and I urge that the Commission be encouraged to devote the lion's share of these new resources to enforcement. At the same time, I am also convinced that a few stiff prison sentences arising from the Boesky affair will be enormously instructive to a new generation of bankers and other Wall Street professionals.

2) Second, it is important that there be legislative clarification of what constitutes "insider trading". To create an effective deterrent to this kind of behavior, we must first get agreement on what it is we want to stop. There is no dispute that what Boesky and Levine did was against existing law. But what about the investment banker who is retained by a prospective raider to facilitate his bid for Company X. Let us say that the banker, to further the interests of his client, lets the word out to the arbitrage community that a hostile bid is forthcoming. The stock begins quickly to flow into

speculative hands, thus advancing the bidder's cause. On these facts, there is a real debate over whether the banker or the arbitrageurs have violated existing law, as interpreted by the Supreme Court. I would like to see that debate resolved. Specifically, let me suggest that this Committee sit down with the SEC and other experts to more precisely define insider trading in a way that includes behavior that borders on the unethical and should be illegal. The SEC has tried to address this problem by adopting rule 14e-3 under the Securities Exchange Act of 1934, which prohibits tipping and trading when one is aware that preparations for a tender offer have commenced. One way for Congress to approach this issue would be to broaden the coverage of and give legislative effect to rule 14e-3.

3) Third, a provision that has needed fixing for quite some time is section 13(d) of the Securities Exchange Act of 1934, which gives a bidder 10 days after crossing the 5% threshold to disclose his holdings. This provision has simply become ineffective in today's market, and it has the effect of permitting the bidder 10 days in which to buy stock at well below the level of his upcoming bid, thus depriving some stockholders of a control premium. In my view, the 10-day window should be shortened to 1 day.

4) Fourth, I believe that we should outlaw the creeping tender. Anyone increasing his ownership to over 20% -- whether by 1%, by 10% or by 80% -- of an issuer's stock should be required to do so in a public tender offer. There is something unfair when a bidder acquires economic control in the open market without paying a control premium and without offering all holders the ability to sell at the same price. I believe that "control" is, in effect, an asset of the corporation that should be transferred only in the light of day, with all holders -- particularly the unsophisticated ones -- having the opportunity to share in the proceeds. This rule should also apply to issuers tendering for their own stock.

5) Fifth, the issue of greenmail -- the repurchase by a corporation of a substantial block of stock from a raider at a premium to the market. This practice is one of the least defensible actions available to a corporation that is being attacked. But it lies within an area of the law that has traditionally been the exclusive domain of the States -- the fiduciary duties of directors under the business judgment rule. I think that the best federal regulatory response to the practice of greenmail is to require full, accurate and advance disclosure of the facts.

The best solution that I have seen proposed so far suggests that, prior to an issuer repurchasing any of its own shares, the issuer should be required to announce publicly:

(i) the number of shares it intends to purchase;

(ii) how the price will be determined for such shares (e.g., fixed price or prevailing market prices);

(iii) how the purchase is going to be made (e.g., tender offer or open market purchases); and

(iv) any arrangement or understanding or contacts with any person within the past 60 days with respect to purchasing shares.

6) Sixth, the Committee should address the growing practice known as "sweeping the street". Several times over the past year, a bidder has withdrawn a tender offer, and then immediately gone into the open market to acquire enough blocks of stock to gain control. The practice enables a bidder to evade the tender offer rules embodied in the Williams Act. Instead of all holders sharing in the benefit of the tender offer on a pro rata basis, a few arbitrageurs who hold large blocks can get preferential treatment. If the party dropping his tender offer were required to observe a two-week cooling off period before re-entering the market, the temptation to engage in the "sweep the street" strategy would be lessened. This problem would also be alleviated by adoption of the suggestion set forth above (#4) that purchases of over 20% of an issuer's stock take place only by public tender.

7) Finally, there would be benefit in clearing up an inconsistency between the Williams Act and the Hart-Scott-Rodino Act. Hart-Scott is intended as an antitrust notification law, not an antitakeover law. The existing filing threshold is $15,000,000 in stock purchases. Hart-Scott should be amended to provide that no notification need be made under that law unless the value of the stock so acquired is more than $15,000,000 and the stock so acquired represents more than 5% of the outstanding. This would conform disclosure thresholds to the Williams Act and eliminate the various means that have been developed to circumvent Hart-Scott, such as options, partnerships and the "investment intent" loophole. It would also ease the burden of review and enforcement of the Justice Department and the FTC. The 5% threshold is low enough for purposes of the antitrust laws.

In conclusion, I believe that adoption into law of these proposals would protect the integrity of our markets, and improve what is already an excellent system. No more is needed.

Testimony by
FELIX G. ROHATYN
Partner, Lazard Freres & Co.
Chairman, Municipal Assistance Corporation
Before
THE UNITED STATES SENATE
Committee on Banking, Housing and Urban Affairs
WASHINGTON, D.C.
Wednesday, January 28, 1987

Mr. Chairman, members of the Committee:

I welcome the opportunity of appearing before your Committee. My name is Felix Rohatyn and I am a senior partner in the investment banking house of Lazard Freres, where I started my career thirty-seven years ago. My work consists mainly of advising corporate clients as to financial matters in general, and mergers and acquisitions specifically. I was a governor of the New York Stock Exchange from 1968 to 1972, and the Chairman of its so-called "Crisis Committee" during those troubled years. I serve on the Board of Directors of several large New York Stock Exchange - listed corporations and as Chairman of the Municipal Assistance Corporation for the City of New York.

Almost two years ago, I testified to your Subcommittee on Securities about some of the issues you will be examining during the coming months. The concern I expressed to you then has unfortunately turned out to understate the facts. As the revelations of illegality and excesses in the financial community begin to be exposed, we, in the financial community, have to face a hard truth: there is a cancer threatening our industry. How far this cancer has spread will only become clear as the SEC and Federal prosecutors bring forth the various investigations currently under way, but it has obviously spread considerably. The cancer is called greed.

It is driven by a general climate of speculation we have not seen since the 1920s; it is not totally unrelated to our continued, huge fiscal deficits; it is encouraged by deregulation and market ideology; it is specifically focused on the recent wave of huge junk-bond financed takeovers and on the various activities related to them. Its most deeply disturbing aspect, so far, has been the Boesky affair.

Before discussing some of the specific issues we will be dealing with here, it is worth noting a relatively new phenomenom. The Stock Market is at an all-time high and booming while business is relatively slow and major sectors of our economy are in serious difficulty. Furthermore, looking to the future, aside from the dollar devaluation, which is a double-edged sword, we see little or no evidence of a realistic willingness to solve our most fundamental economic problems: our budget deficit, our trade deficit and the vulnerability of our banking system. The financial markets now have a life of their own, seemingly unrelated to many underlying economic realities. The need for productive investment in this Country, together with the risks created by the level of existing speculation, make it more important than ever that the integrity of the markets be assured and that capital be used to build and not to speculate. This is the framework in which the current issues should be considered.

The questions raised by recent events should be examined in two contexts:

1) Illegal activity and the adequacy of existing laws and regulation to deal with it;
2) The implications to the economy of the present level of takeover activity, with specific focus on potentially dangerous levels of leverage.

With respect to the former, I will leave it to other witnesses to comment on enforcement and the possible need for other tools to catch wrongdoers. However, there is obviously a broader issue involved here, namely that of the ethics of a profession where integrity has to be fundamental. After all, the word "credit" comes from the Latin meaning "to believe"; belief in the integrity of our financial system is certainly open to question at this time.

The explosive growth in financial services, and the huge rewards related thereto, have caused obvious strains on the ability to maintain relatively old-fashioned standards and traditions while adjusting to the pressures of the new deregulated environment and the technologies which allow endless development of new products. Investment banking firms, law firms, arbitrage firms, investment advisers, etc., have grown often tenfold in personnel over the last few years. In most cases, much of the growth has been accomplished by hiring young college graduates, MBAs or law students and having them involved in high pressure, high profile and extremely sensitive activities such as mergers, large block trading and arbitrage

An industry which traditionally provided independent financial advice and distributed securites on behalf of its clients has turned into a business creating and selling new products and relying more and more on the trading of securities for its own account to generate profits. Long-term relationships are no longer valued; it is the age of the financial samurai. The same is true of many law firms. And the behavior of financial institutions is mostly geared to short-term results. The fact that this is as much the fault of the clients as of the lawyers or bankers is beside the point; the result is what counts. Too much money is coming together with too many young people, with little or no institutional memory for tradition, under enormous pressures to perform and under the glare of Hollywood-like publicity. It is a recipe for speculative excesses at best, illegality at worst. Insider trading is one manifestation of this cancer. No firm, even my own, is immune from it, no matter how carefully it handles sensitive information. We have to rely on the ethics and the character of our people; no system yet invented will provide complete assurance.

It is against this background that we should look at the present situation from the point of view of the public interest. It is also important to remember that merger and takeover activities include not only investment bankers, raiders and arbitrageurs. Lawyers, commercial banks, and maybe most importantly, large institutional investors, all play an important role. Furthermore, these activities have become international in scope, with emphasis on the London market.

The issues involved here are three-fold:
a) The integrity of our securities markets;
b) The safety of our financial institutions;
c) The constructive use of capital as an engine for growth.
These are all jeopardized by what is happening today.

Over the long run, the capital markets self-correct, but sometimes abuses become so widespread that the markets must be helped by legislation or regulation. Today that is the case in respect to takeovers. The abuses fall into several general categories:

a) Unequal treatment of shareholders as part of offensive or defensive corporate actions;
b) Unsound financial structures as a result of excessive leverage;
c) Destabilizing impact of large scale arbitrage and other short-term trading activities as an integral part of mergers and takeovers.

I would like to examine each of these briefly.

a) The basic concept of our securities laws has been full disclosure, non manipulation, and equal treatment of all shareholders. Both the techniques of current takeovers as well as current legal trends undercut these concepts.

In tender offers, two-tier takeover bids heavily favor professional traders to the detriment of non-professionals. Bids that are made "subject to financing", in many cases directly or indirectly financed by junk bonds, permit the bidder to manipulate the markets without committing himself to purchase. The resulting activity by arbitrageurs and short-term traders create speculative accumulations which, in the parlance of the trade, "put the company into play". Whether the outcome is "greenmail" or a "white knight" rescue, the result is a large profit for the raider, at minimal risk.

Because of these tactics, defensive maneuvers have been devised that are equally objectionable to shareholders. The payment of "greenmail" is the most obvious and, in many ways, the most old-fashioned of these maneuvers. Selective repurchase of stock, "lock-ups", "crown jewel options", "shark repellent" and "poison pills" of one kind or another, all have been designed to enable managements and boards of directors to interpose themselves between the shareholders and takeover bids. State takeover statutes giving management and directors almost unlimited licence to entrench themselves are becoming more frequent. These can be used against bona fide bidders as well as against the more pernicious types.

The most basic elements of stock ownership, i.e., equal voting rights and equal equity ownership for all common shareholders are now under attack. For instance, the NYSE has allowed the listing of common shares with unequal voting rights; and recent decisions in Delaware permit, in certain cases, unequal payment among common shareholders.

b) As a result of this activity, financial structures are seriously eroded. In recent years, some of the largest takeovers were brought about as a result of raids, financed by junk bonds, on the target companies. Most of these were then acquired by third parties. A large part of the oil industry has been reorganized as a result. The mergers of Chevron-Gulf, Occidental-Cities Service, Mobil-Superior all occurred as a result of raids or the threat of raids. The deterioration in their combined balance sheets has been dramatic. Far from being a healthy restructuring, the oil companies involved are cutting exploration sharply, a practice our country will pay for dearly when the next energy crisis occurs. With their high levels of debt, they could be in serious difficulty if the price of oil declines again. If one were to write a scenario about how to get the U.S. into trouble as far as energy is concerned, it would be hard to improve on what has happened.

It is in the area of large takeovers that the junk-bond phenomenom is particularly hazardous. High-yield, low-rated debt, in reasonable amounts, is a perfectly acceptable financing vehicle for many companies ineligible for investment-grade credit ratings. It is a different story, however, when this type of debt, in the billions of dollars, is used to substitute for equity in the takeovers of very large companies.

The **Chairman**. Thank you very, very much, Mr. Rohatyn, for a fine statement.

Mr. Cutler?

STATEMENT OF LLOYD N. CUTLER, ESQ., PARTNER, WILMER, CUTLER & PICKERING, WASHINGTON, DC

Mr. **Cutler**. Mr. Chairman, I am not a financier or an economist like the rest of this distinguished panel. I am a lawyer, like many of you.

It seems to me that, while I agree with everything that has been said so far, in large part, that one aspect of this has not been touched. All of the other panelists have referred to this really disturbing equity decapitalization of American industry. It is running at the order of $70 or $80 billion a year on a base of roughly $1 trillion of book equity capital of all nonfinancial business corporations.

That is very significant, year by year. Mr. Greenspan said the effect over a 3-year span since 1984 has been something like $240 billion. At the same time, corporate debt has gone up by a corresponding even larger amount. Much of that is attributable to the takeover phenomenon, and in particular, the fashion of junk bonds and the defensive measures which corporations like Phillips, some of the other oil companies, Unical, CBS, USX and others have had to take. Probably there has been more decapitalization as a result of these defensive measures, if anything, than by the actual takeovers themselves.

Much of this is fueled by the junk bond. The junk bond is a tax shelter provided by our tax laws for converting equity into debt to the point where, instead of two-thirds equity, which has been the average for many years for most industrial corporations, we are now dropping well below that. We may soon be at 50-50, and we have many, many companies now with only 10 percent or 20 percent equity.

The driving force behind all of that, apart from the profits that can be made in the market by doing these things, is that under the tax laws, a large share of the cost of debt capital is deducted and is paid for by the American taxpayer. That, in very large part, I think, is what is driving this junk bond phenomena.

MARGIN RULES ERODED

Another element that is driving is that the ordinary margin rules applied by the Fed, under which you can only borrow 50 percent of the market value of the share, were not, until very recently, applied to takover purchasers of shares, who were, in effect, borrowing from banks and through junk bonds on the future security of the assets of the company they had not yet acquired and were really borrowing on the shares they had.

The Fed did take a measure to restrict that and apply the margin rules to these transactions last year, but it is a half measure that has readily been evaded as new ways of takeovers have been developed.

I have tried to suggest in my paper, my testimony, how corrections could be made, both in the margin rules, which I believe are within the jurisdiction of your committee, and also in the tax law. We could, for example, say that we would eliminate or at least reduce the tax deductibility for interest on debt used to purchase 10 percent or more of the shares of your own company or any other company.

We could expand on the so-called thin incorporation rule, which, if you have a subsidiary with a very low amount of equity and a large amount of debt advanced by the parent, the debt part of that debt is treated as equity, which it really is. Most junk bonds are nothing more than preferred stock in wolf's clothing.

And all of that is being done at the expense of the American taxpayer.

Section 279 of the Tax Code already limits interest deductions for debt issued to acquire the stock of another company, but only if the debt is convertible, and if the resulting equity-debt ratio falls below certain limits. That can readily be evaded today by issuing nonconvertible junk bonds. There is something else that could readily be fixed.

I would only make one further comment on the greenmail issue. It does seem to me that the best way of stopping greenmail is to adopt a rule under which no shareholder having a control block, let us say a Williams Act threshold block, 10 or 5 percent, could sell that block at a premium, significant premium over market, to anyone, including the corporation, unless he got the same thing for all other shareholders, which would be roughly equivalent to rules that apply in the city of London today.

And I will stop there, Mr. Chairman.

[The complete prepared statement follows:]

The risk in this type of operation is twofold. First, in the actual security of the paper. If the takeover is successful, the servicing of very high levels of debt, at rates of interest in excess of most targets return-on investment, requires significant asset dispositions which may not always be possible or desirable. It is an approach that also completely fails to take into account the fact that a large corporation is an entity with responsibilities to employees, customers and communities, which cannot always be torn apart like an erector set. The alternative to a breakup requires significantly improved cash flow performance. This requires cutbacks in R&D, capital-spending, and usually, significant reductions in employment. It may cause some companies to be leaner and more competitive; It may also require sacrificing the future.

The second element of risk in this type of paper is liquidity. Even though much of this paper is sold to financial institutions such as savings banks, insurance companies and pension funds, in many instances, no large scale, liquid public market exists in these securities and purchases and sales are handled through private transactions. It should be noted that many of the investing institutions are in financial sectors under considerable pressure at this time.

To protect themselves against this type of takeovers, companies have begun large scale restructurings of their own whereby they assume significant amounts of additional debt in order to shrink their equity and increase the price of their stocks. FMC, Colt Industries, Owens-Corning Fiberglass, Gillette and Goodyear are the most recent example of this trend. In addition, Goodyear and Gillette paid vast amounts of "greenmail". Excessive debt to equity ratios are the result. Whether in the long run, this is sound financial policy and good for the Country is open to question. It is obvious that these restructurings are driven more by the fear of takeovers than by straightforward economic forces.

Junk bonds, of course, are not the only source of excessive leverage in recent takeover activity. Large scale leveraged buyouts and "going private" transactions have been financed by bank and institutional loans as well as by junk bonds. They have to be judged on a case-by-case basis. In many cases, some simplification of corporate structures may be quite appropriate and no junk bond financing is involved. But, the result, in most cases, is more and more substitution of debt for equity and less and less stable financial structures.

c) Added to this combination of unequal treatment of shareholders and unsound financial structures is the market speculation which has become an integral part of the process. Very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools are financed by junk bonds. Equally large pools of money are in the hands of raiders, similarly financed. This creates a potentially interlocking set of relationships which has as its basic purpose the destabilization of a large corporation and its subsequent sale or breakup. It creates, at the very least, the appearance, if not the reality, of professional traders with inside information, in collaboration with raiders and junk bond buyers, deliberately driving companies to merge or liquidate.

Another important and related factor is the behavior of institutional investors. Between $75 and $100 billion of junk bonds have been placed over the last five or six years. Probably half this amount has been directly related to takeovers, leveraged buy-outs and restructurings. Only financial institutions can provide purchasing power in such size. The cornerstone of junk bond takeovers is the willingness of financial institutions, fiduciaries for depositors, retirees and policy-holders, to acquire this paper in vast amounts. Insurance companies, savings-and-loans, pension funds, commercial banks, all want to show short-term performance with high-yielding assets; so far, the experiment has been a success. Interest rates have declined steadily over the last five years and the stock market has boomed. What happens in a downturn is a different issue, especially if that downturn is accompanied by rising interest rates as a result of foreign capital flight. There are several fiancial time bombs ticking in our closet; this is potentially one of the largest and most dangerous.

In summary, what does all this add up to?

1) At a time when we are trying to encourage long-term investment, this activity encourages speculation and short-term trading;

2) At a time when we are trying to strengthen our important industries to make them more competitive, this activity weakens many of our companies by stripping away their equity and replacing it with high-cost debt. Leverage can promote growth when borrowed funds are used to make new investments to meet future market needs and be more competitive. It is quite another story when leverage is created to pay out shareholders today at the expense of growth tomorrow.

3) At a time when our financial institutions (banks, savings banks, insurance companies) are under considerable pressure, this activity preempts more and more general credit and causes the weakest sectors to acquire large amounts of risky and possibly illiquid paper to show performance. Much of this paper has never been tested in a period of economic downturn.

4) At a time when we need to continue attracting capital from all over the world, our securities markets appear to be more and more under the control of professionals and insiders.

I believe that these issues are sufficiently serious to warrant the relevant regulatory authorities and the Congress to consider more stringent regulation coupled with new legislation.

Some or all of the following areas should be studied:

1) Junk Bonds

a) Limit the amount of below-investment grade paper, which can be carried by Federally and state-insured institutions;
b) Require a higher standard of care and prudence from directors, officers or trustees investing in this type of paper, if they are to be protected by indemnification provisions under their charter or by-laws; make it clear that achieving the highest short-term investment returns is not the main Fiduciary obligation.
c) Limit the tax deductibility of interest by highly leveraged companies which have acquired significant amounts of their own, or another company's stock or assets;
d) Review whether "disclosure" is a sufficient standard to qualify securities for registration under the Securities Act.

2) Takeovers and Tender Offers

a) Require 100% financing commitments before allowing a tender offer to commence;
b) Lengthen the tender offer period to 60 days;
c) Require a one-price, 100% offer for any buyer wishing to acquire more than 20% of another company.

3) Financial Institutions

Consider a tax on the profits on securities transactions of presently tax-free institutions in inverse proportion to their holding period.

4) Arbitrage, Hedge Funds, etc.

Consider limiting the right to vote on major corporate matters such as mergers or restructurings, to shareholders with a minimum holding period, say one year.

At the same time, if takeover excesses are curbed, abusive defensive tactics must also be curbed. Not all takeovers are bad, not all managements are good, not all directors represent the shareholders best interests. Takeovers do not have to be friendly; they have to be fair and soundly financed. The following should be considered:

1) Outlaw all forms of "greenmail";
2) Re-establish the principle of "one share - one vote";
3) Eliminate any form of "poison pill".
4) Require shareholder vote on any bona-fide offer for 100% of a company, or on major restructuring proposals;
5) Eliminate "crown jewel options", "shark repellents", and all other defensive strategems designed to discourage a bona-fide bidder;
6) Override state takeover statutes which provide management and directors with almost unlimited license to turn away bona-fide bidders and entrench themselves.

I am obviously not suggesting that all of these should be adopted, but they are all elements of the various issues involved here. The objective of any legislative or regulatory approach should be to create a level playing field as to bidders and targets, and return as many major corporate decisions into the hands of investment-oriented shareholders.

I have been an investment banker for more than thirty years. It has been an honorable profession; I want it to stay this way. I have negotiated hundreds of mergers and acquisitions for a variety of corporate clients. Most of these were the result of negotiated agreements; some were bitterly contested, hostile takeovers. All of them were properly financed. I hope to continue this activity for many more years. It is an integral part of the service an investment banker should provide his clients and it is an important factor in maintaining a competitive market place. There is no question in my mind that thoughtfully negotiated mergers have a better chance of achieving their objectives than multi-billion dollar takeovers, or major restructurings, decided upon over a weekend, as a result of a raid. Nonetheless, there should be room for many types of transactions in our market system, but very clear lines should be drawn between what is acceptable economic and corporate behavior on the one hand, and what is runaway speculation on the other. That is not the case today.

There are always arguments against any changes. The political power of the junk bond lobby was in evidence last year when Federal Reserve Board Chairman Paul Volcker barely won the right to effect a minor change in the margin rules against fierce opposition. Both in the Senate and the House, arguments for legislative change were brushed aside. However, the integrity of our securities markets and the soundness of our financial institutions are vital national assets. They are being eroded today.

The picture of greed and corruption presently in the headlines could unleash a vicious backlash against financial institutions as well as individuals. Individuals who break the law must be punished; institutions should be reformed. The securities industry is, and has been, heavily regulated since the 1930s. It has operated successfully and comfortably in a highly regulated environment. The notion that additional legislation would interfere with the operation of a totally free market is a complete myth in this particular case.

I believe that as a result of the ongoing revelations of scandals, the securities industry will have to accept new legislation and regulation to curb the speculative abuses of the past several years. This is long overdue. Instead of trying to fight against the inevitable, I hope that financial industry leaders will cooperate with the Congress in the coming legislative hearings to help shape rational laws and rules to reform the system. If they do, our financial market system will emerge stronger and cleaner from its inevitable torment; if they do not, the resulting legislation may be so punitive as to result in detriment to all.

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STATEMENT OF LLOYD N. CUTLER

Before The

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Of The

UNITED STATES SENATE

On The Subject Of

HOSTILE TAKEOVERS

January 28, 1987

There is much debate about the micro- and macro-economic effects of corporate takeovers financed by junk bonds. Most of this debate focuses on whether or not such takeovers shake up or shake out weak managers, more efficiently deploy corporate assets, enhance market values for shareholders or create a beneficial degree of "freedom" in the "market" for corporate control.

There is much to be said on both sides of these issues. But there is another much larger issue that deserves attention -- whether the resulting change in corporate equity-debt ratios will have a seriously adverse macro-economic effect on the strength and resiliency of the U.S. economy. On that issue, there is a strong case for correcting government policies that encourage corporate takeovers (and defensive measures) financed by junk bonds.

In general, and despite the tax bias in favor of corporate debt, U.S. manufacturing corporations have maintained equity to debt ratios of at least two-thirds equity. There are disturbing signs that this ratio is declining, and that corporate takeovers (and defensive stock redemptions) financed by junk bonds are the reason. From 1980 to 1984 (the last year for which published figures are available), the equity-debt ratios of all manufacturing corporations declined from 2.3 to 1 to 2.1 to 1, a drop of almost 10%.[1] In 1983 (just before the junk bond market began its remarkable takeoff), new equity issues by non-farm, non-financial corporations exceeded equity redemptions by $28 billion. In 1984, equity redemptions exceeded new equity issues by $72 billion -- a negative swing of $100 billion in a single year -- in sharp contrast to the net positive volume of new issues over redemptions for the six-year period 1977-1983.[2] Since total retained 1984 earnings of all manufacturing corporations were only $59 billion,[3] this means that in 1984 the equity decapitalization rate of American manufacturing corporations more than offset the reinvestment of retained corporate profits.

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[1] Statistical Abstract of the United States (1986) 535. According to a Data Resources Inc. table published in the Washington Post for January 11, 1986, p. G-1, the equity-debt ratio of American non-financial companies is even lower, reaching 1.1 to 1 in 1986.

[2] Ibid., p. 533.

[3] Ibid., p. 535.

When the 1985 and 1986 figures become available, they will probably accentuate this negative trend. Preliminary Department of Commerce data indicate that in 1985 equity redemptions exceeded new issues by $81.6 billion, that retained earnings were only $51 billion, and the overall equity-debt ratio declined to 1.9 to 1. Private estimates show comparable trends in 1986.

What are the implications of this steepening decline in equity-debt ratios?

First, as more and more corporations succumb to takeovers or succesfully defend by repurchasing their own shares, the equity-debt ratios of these companies will shift from 2/1 equity/debt to 1/2 or even 1/10 or 1/20 equity/debt.

Second, the national average equity-debt ratio will decline from 2/1 toward 1/1 or even lower.

Third, this shift, by transferring corporate payments to investors from non-deductible dividends to deductible interest, will reduce federal tax revenues from corporations at a time of large budget deficits.

Fourth, the huge volume of junk bonds required to finance these retirements of equity is being purchased and held by savings banks, insurance companies and pension funds -- fiduciaries investing other people's money -- rather than by individual investors directly.

Fifth, unless the age-old economic laws of financial soundness and the business cycle no longer apply, the time is surely coming when many of these highly leveraged junk bond issuers will be unable to generate the cash flows needed to service their enormous debts and will go into bankruptcy or even liquidation.

Sixth, the cessation of interest payments by those who do enter bankruptcy will threaten the solvency of many fiduciaries holding junk bonds, and could well cause a panic in the bond markets.

Seventh, and perhaps most threatening in the long run, all of this equity disinvestment, asset liquidation, debt creation and intermediation of people's

savings is directed toward the purchase and resale of existing financial and physical assets rather than the creation of any significant new capital plant or technological research.

From an overall macro-economic point of view, the implications for the stability, competitiveness and growth of the U.S. economy could hardly be more ominous. It requires a remarkable tolerance for letting markets regulate themselves to view these risks with equanimity. Only those who would have opposed the creation of the SEC after the 1929 crash can consistently argue that the Government should leave the junk bond phenomenon alone.

For those who are deeply concerned about these risks, two types of remedial measures are worth considering:

1. The Federal Reserve's Margin Regulations.

The Federal Reserve has statutory authority for setting "margin" or collateral standards on borrowings to purchase equity securities. Under this authority the Board has fixed a maximum loan value of 50% of market price for equity shares or other collateral. While the Board would prefer to be out of the margin regulation business entirely, it has become sufficiently concerned about the impact of junk bond borrowings to issue an interpretation of the margin rule that effectively bars some types of junk bond financing for corporate takeovers that were in use before the interpretation was issued, but which does not cover other types that have subsequently been developed.

It would be feasible and lawful for the Board to promulgate a much more sweeping margin rule that would sharply restrict the use of junk bonds or other borrowings to finance the purchase of large equity blocks for control purposes. Every effort should therefore be made to increase the Board's level of concern about the degrading of corporate equity-debt ratios and the growing diversion of national savings by fiduciary intermediaries, including depository institutions, into highly volatile junk bond issues.

2. The Tax Code's Bias Toward Junk Bonds.

By generally allowing a full deduction for corporate interest payments on debt, the tax code provides a huge incentive for replacing equity with high-yield debt. Assume a corporation with $100 million in after-tax earnings, 20 million shares selling at $55 or 11 times earnings, and a 1987 tax rate of 40%. If it (or a takeover bidder)[4] purchases 16 million of

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[4] It is assumed that the takeover bidder would buy all the outstanding shares and then recapitalize so that only 20% of the original shares remain outstanding.

The **Chairman**. Well, thank you very much. Thank you, gentlemen. I think this has been a most enlightening panel.

I would like to start off with Mr. Rohatyn, who makes the statement on page 2:

> The implications to the economy of the present level of takeover activity, with specific focus on potentially dangerous levels of leverage.

And then Mr. Rohatyn, I've got great admiration and respect for you. You are a brilliant writer as well as a smashing success as an investment banker, but you give a series of recommendations which correspond with what Senator Metzenbaum has been fighting for, and I disagree with him on most of them, because of the effect, the consequences. What do you do about stopping corporate takeovers, if you outlaw all forms of greenmail, reestablish the principle of one-share one-vote, eliminate any form of poison pill, require shareholders to vote on any bona fide offer for 100 percent of the company, eliminate crown jewel options, shark repellents, and all others?

What you are saying, it seems to me, is, you're telling the corporation that wants to defend itself against a takeover, give up all your arms and negotiate from no position of strength.

Mr. **Rohatyn**. No, Senator, what I——

The **Chairman**. Won't you have a lot more takeovers, if you follow your prescription?

ELIMINATE BOTH DEFENSIVE AND OFFENSIVE ABUSES

Mr. **Rohatyn**. Yes, but my recommendations, Senator, were not to eliminate the defense, unless you eliminate the takover abuses. I think that you state by eliminating the takover abuses, and I have listed a whole slew of them. I don't think you allow tender offers that are subject to financing. I think if you limit the ability of financial institutions to buy junk bonds, if you make fiduciaries liable if they buy paper that goes belly up a few years later, if you limit the tax deductibility of junk bonds, and if you do—I think there were eight or nine suggestions that I made—you are then eliminating the takeover abuses on the offensive side, and what I was trying to say is that if you do that, then it seems to me, you shouldn't permit the defensive abuses, some of which have been as damaging to companies that have restructured themselves as the takeover abuse, because the result is the same.

If you pay $500 million of greenmail, and then you issue your own junk bonds, in order to shrink your capitalization by 50 percent, the net result to the American economy is no different than if the takeover raider has done that. I think if you eliminate the one, then you probably don't need the other, but that is the context within which I was making these recommendations.

The **Chairman**. What you are telling us then is that these should not be done in isolation.

Mr. **Rohatyn**. Absolutely. If I didn't make that clear——

The **Chairman**. If we can't do something really effective about the offense and just put in the defense, it could make matters worse.

Mr. **Rohatyn**. All my brilliant writing is for naught, if I didn't make that clear, sir.

The CHAIRMAN. Well you made it clear now in response to this question. [Laughter.]

You see, otherwise, we have to rely on what I find, and Senator Metzenbaum, too, has found, is a very, very feeble situation, where we rely on antitrust action. There was a time in American history, both in Republican and Democratic administrations when antitrust was the cry. The best regulation you can have, antitrust. Have some real competition. We all know that that is not a very effective reliance at the present time.

Mr. Brady, on April 25, you wrote an article in the New York Times entitled: "Equity Is Lost in Junk Bondage." In that piece, you were extremely critical of junk bonds used to finance hostile takeovers. With respect to borrowed funds used to acquire a target company stock, you wrote and I quote: "This imprudent debt binge creates a mandate to lay off people and sell assets."

You also said that, "What is new and dangerous is the rapidly expanding use of securities to advance highly leveraged hostile acquisitions."

My question is: What restrictions, if any, would you place on the use of junk bonds to finance highly leverage hostile acquisitions?

Mr. BRADY. I think Felix thought that federally insured institutions should have some rather stringent guidelines about what kind of securities they can purchase, particularly junk bonds, is a good one. I think one thing that is going on right now, Senator, is that for some reason, and it may have a direct relationship to the Boesky affair, is the amount of takeover activity in junk bond financing that we have had since the Boesky affair broke, has slowed to an absolute walk. I mean, I can hardly think of a takeover transaction that has happened since this scandal hit. And I think the instructive nature of what happens to you when you do that kind of thing if crookery is involved is tied closely to the amount of junk bonds that have been issued.

I also think that the tax laws enacted this last year, which will make the deductibility of interest less attractive because the tax rate is coming down, and the fact that the stock market is going up, will mean that corporate managers, if they do engage in takeovers, will do so with equity.

The CHAIRMAN. Thank you very much, sir.

My time is up, unfortunately. I wanted to get to Mr. Cutler, but I don't have time.

I hope that you gentlemen will consider also recommending in the future that—I talked to the Federal Reserve Board about their execution of margin requirements and pointed out that junk bonds seemed to be free of them. A big raider can go out and he can get billions of dollars without putting up any of his own money and just finance the whole thing on a junk bond issue.

NEED PRIVATE RIGHT OF ACTION

Well, the Federal Reserve Board tells me that what you need is a private right of action, so the corporation can sue to require that the takeover people proceed to buy stock as everybody else does on margin requirements that are effectively enforced. Senator Hecht.

Senator Hecht. Thank you, Mr. Chairman. You brought up a very good point at the beginning, which I have just been sitting here mulling over in my mind, about all the things that everyone has said we should be doing and all the laundry list of different requirements that this committee should look at, the tax bill overhaul which we should look at.

Now let's be very, very practical. It's great to come before the Senate Banking Committee and say this is what you should do and then go back home and say, if they would have done what I told them to do, we wouldn't have these problems today. But we've got to be practical.

Do you actually think that this Senate committee could pick up all these points that you are mentioning, go to the full Senate, go to the different House committees that have to work on it, and come up with a bill that would be good for American business?

Let's look at the facts today. There are 13 million more Americans working, as the President said last night. The stock market is at an all-time high. So maybe something isn't really wrong.

Mr. Rohatyn, do you really think this committee can do what you asked it to do?

Mr. Rohatyn. Senator, my job isn't to try to figure out what this committee can do. I was asked to come here and testify about what I see as some of the problems involved here, and I tried to make some suggestions as to areas that I think are worth looking at. In your wisdom, you're going to decide what you can do and what you want to do. All I can do is answer your questions.

Senator Hecht. What can be done at the SEC level that does not have to be brought to this committee? Nick, you have served in the U.S. Senate. You have a practical approach to this.

Mr. Brady. Well, Senator Hecht, I think that we simply need more cops on the beat at this particular time. I am a great believer that the people in our industry and others, if they see a few stiff prison sentences handed out here, they are going to behave in an entirely different manner. So I think when you get the appropriation for the SEC, and I haven't been a guy that's wanted a bigger SEC my whole life, I'd go for it. I'd go with it. Let's get some more enforcement. Let's enforce the laws we have on the books. I think it will make a difference.

Senator Hecht. You mentioned the marketplace has reacted to the Boesky affair, and there have not been takeovers. Do you think the marketplace will continue to react to the different problems that arise?

Mr. Brady. Well, this is a personal opinion, obviously, but I was in the Senate when we were discussing the fact that the interest rates at 19 percent ought to be brought down, and we, all of us, were trying to think of ideas how we ought to do that. Take over the Federal Reserve, do this and that. It seems to me that our system works. Unfortunately, you can drown in water that averages 2 feet deep, and it is painful to sit and watch it work.

I really believe that if you take some of the things that Felix has suggested here, and I've suggested and Lloyd has suggested, work the laws over and let the process work on the insider trading transactions—you are going to see it stop by itself. You don't need landmark Draconian legislation. You need plenty of implementation of laws that we've got and changes that have been suggested this morning. It will work.

Senator HECHT. Just give me those changes. Be specific what you think we should do and what the SEC should do with more cops.

Mr. BRADY. Well, I have submitted suggestions in my statement, Senator Hecht, but just to take section 13(d), we've all been talking about it for 2 years. I wouldn't waste any more time on that. Senators have suggested too that the 10-day period ought to be brought down to 2 days. Why not make it 1? Let's get it over with. I think that in the case of insider trading this committee ought to look very closely at the relationship between bankers, lawyers and arbitrageurs and extend the insider training laws to cover unfortunate situations that I believe have been going on in that particular area.

I have given some other changes, such as creeping tender offers, which I think are unfair to the little guy. You ought to have a situation where everybody gets the same price. I picked a level of 20 percent as threshold. Felix might pick another figure. I wouldn't argue with him. I think in the case of sweeping the street, where a guy says he is going to tender, and then he says he's not going to and just comes in and does the same thing by buying all the stock. I think there ought to be a cool-off period there.

I think if you perfect those laws, you will make a very, very useful change in how these activities are undertaken.

Mr. CUTLER. Senator, you have very specific proposals that have been submitted to the committee in draft legislative form by Martin Lipton and others, amending the Williams Act and other SEC provisions that are well worthwhile doing. You also have jurisdiction over the Federal Reserve Board and its margin regulations.

Senator HECHT. What I am saying to you, Mr. Cutler, in my 4 years here as a United States Senator, and you mention about you are an attorney, and there's a lot of attorney in Congress, I agree on that, but I just say the practicality of doing a good job is very unlikely, and sometime when you start messing with a system that has worked and it is working right now, the cure sometimes is worse than the disease. That is the reason I say we have to go very, very slowly on legislation in this United States Senate. That is my opinion to you.

How do you feel about that?

DECLINE IN EQUITY CAPITALIZATION

Mr. CUTLER. Well, I respectfully disagree, Senator. I think you do have an alarming condition of which the most important element is this steady decline in the equity capitalization of American companies. You are witnessing a decapitalization of the equity of American companies. I think that is something to be concerned about, and every member of this panel has said that is something to be concerned about. And it is directly attributable to the takeover financed by the junk bond.

Senator HECHT. Thank you.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Sanford is next, and I am going to ask Senator Sasser to take over the gavel, because I am going to step out for just a minute to answer a phone call. Senator Sanford.

Senator SANFORD. Senator Hecht, I think we can put together some legislation that will get at these abuses. I have been watching this business, in fact, participating in it, and was involved, to some extent, in takeovers for the last dozen years. I think there are some things that can be done. I look forward, in fact, to having a hand in shaping up some of the practices.

Senator Brady, I suppose that we honor you by putting that title on you here. I'm not so sure it does you any good in Wall Street—[laughter.] It might affect your credibility. But we are delighted to have you here, and I thank you very much for not only the thoughtful statement that you bring to us today, but the thoughts that you've been expressing since you've been back in your position outside the Senate.

I was a little bit worried when you said, "if it ain't broke, don't fix it," because I thought it was broke, but then I realized you meant don't replace it. But we can fix it. And I like, certainly, your thrust there.

I'd like just to ask you elaborate on one other point, because I have observed now that a great many investment houses are moving around the corporate world and saying, let us tell you about the leveraged buyout. Especially when that is said to management, it appears to me to be a rising abuse, where management takes advantage of its position, affecting a leveraged buyout mostly for its own benefit and if not, the buyout is to the absolute detriment of the stockholder and certainly to the ultimate detriment of the system.

Could you comment just a little on that kind of buyout?

Mr. BRADY. Well, I think you are right when you put that kind of leverage in borrowing in a situation. If it works, people make a lot of money. If it doesn't work, they don't make a lot of money. But I think the leveraged buyout is a mixed blessing. On the one hand, it certainly is going to make American corporations operate with less bureaucracy. It may, in the short term, convince them not to spend money on research and development. Certainly, reduction in work forces, asking people to go look for jobs elsewhere. It's tough. But I think it is a mixed blessing. I think that there is no question in my mind that even our corporate managers in this country have decided that they can run things a lot leaner than they have, and the restructuring and leveraged buyout thing is a method by which that takes place. It is a mixed blessing.

Senator SANFORD. Well, thank you. I'd like to ask Felix, if he would comment on this management leveraged buyout trend that seems to me to be developing, and do your recommendations get at that adequately?

Mr. ROHATYN. Well, Senator, I think I would—again, I think Nick and I are pretty much in the same place. Leveraged buyouts create situations which, in the long run, require companies to be run for cash flow rather than for future growth, and certainly from an overall point of view of growth in the economy, the go in the opposite direction.

On the other hand, again, if they are appropriately financed—I mean, if we are not dealing with junk bond, if enough equity is in the structure, and if full disclosure is made to the shareholders, so that management can't take advantage of information that it has and that isn't available to the shareholders, and first of all, that the shareholders can vote on it, and second, that any bid higher than the management bid will be considered, then I think I wouldn't interfere in that process, within those parameters.

Senator SANFORD. But your suggestions about the hostile takeovers would fairly well help moderate this system of management takeovers?

Mr. ROHATYN. Well, I think that one of the suggestion that I was making—really, I tried to differentiate—this question of hostile or friendly takover is—I don't really make that differentiation. I make the differentiation between takeovers that are fair to all the shareholders and that are appropriately financed, and I think it is on those two standards that I would test the leveraged buyouts. And I think those can be met.

Senator SANFORD. Well, I heard you say that, that there wasn't much difference between hostile and friendly takeovers, except that you would measure it by whether the takeover was fair. But as a matter of fact, the hostile takeovers generally aren't fair to the stockholders. So the motivation of the takeover seems to me to have an important bearing. I think all of your suggestions get to that, and I thank you.

Mr. ROHATYN. Thank you, Senator Sanford.

Senator SANFORD. Lloyd, let me just ask you one question. Well my time is out. I was going to ask you when junk bonds are justified, and maybe we will get a chance to get back to that.

The CHAIRMAN. Thank you, Senator Sanford. Senator Shelby.

ROLE FOR HIGH-YIELD BONDS

Senator SHELBY. I think Mr. Greenspan answered one of my questions. Was there basically a role for high-yield bonds or junk bonds, and my reference was, I think, into emerging companies. I would like to have your comments on that, and if you do curtail the use of high-yield bonds, what will it do to companies that are seeking capital, that are not high grade—couldn't qualify for high-grade bonds?

Mr. BRADY. Well, I think you put your finger on the problem, Senator. There are all kinds of what we refer to as junk bonds. The junk bonds that we are all being critical of this morning are not the junk high-yield bonds that finance the growth of a company that isn't able to get into the regular credit markets and has to pay more interest to get it. I would submit that the bonds that saved the Chrysler Corp. were junk bonds. The real problem here is in defining and trying to get at something we are all worried about. Do we stop these other activities, financing emerging growth companies and giving some life into what has been referred to as the fallen angels, the Chryslers and some of the steel companies, who people don't want to invest in, and you've got to give them a high interest rate, in order to make them do that.

Senator SHELBY. The term has been used here and elsewhere that markets will self correct, whether they are a high-yield bond, junk bond market or what. In the downturn in 1981–82, what was the experience in the recession, the worst one in many years, as far as the junk bond portfolios were concerned? Do you have any comment?

Mr. ROHATYN. I think, Senator, the vast majority in the junk bonds that have been issued have been issued since that period. And I think the real problem here is that you by now have, I don't know, 7,500 billion of those securities out there, which have never been tested in a downturn. If there is a downturn, and I don't think you can eliminate the possibilty of a downturn——

Senator SHELBY. Or probability.

Mr. ROHATYN. Or possibility. And the fact that we could have a downturn with higher interest rates as a result of capital flight, you would be dealing with a vast amount of securities in institutions that are insured or that are supposed to protect retirees, policyholders, et cetera. So that what you are looking at is a situation where if something goes wrong, the taxpayers will be footing a lot of the bill.

I am not at all against the notion of consenting adults buying junk bonds in private, as they do anything else. [Laughter.]

But I do think that as a public activity, it is something that has to be looked at and that simply putting a statement on a prospectus that says the likelihood of this company servicing its bonds, paying interest and principal is remote, is not enough of a test to permit a financial institution to invest in them.

Senator SHELBY. But the real test would be a severe recession, would it not, for a high-interest rate?

Mr. ROHATYN. Well, it is not something that I would like to see as a test, Senator, because I think it would be very expensive.

Senator SHELBY. Well, we don't want to see the test.

What percent of, say, the portfolios of the savings and loans or thrifts in the country, government-insured institutions, are invested in high-yield bonds?

Mr. ROHATYN. I think, Senator, that probably varies sharply among institutions. I have no problems having a limited amount, a limited percentage of an institution's portfolio in high-yield securities. I think that is perfectly acceptable.

Senator SHELBY. Some of them are in mortgages, though, are they not?

Mr. ROHATYN. I beg your pardon?

Senator SHELBY. Most of their money is in first mortgages.

Mr. ROHATYN. Well, I think you have a lot of—you have some savings and loans with a very high proportion of portfolios in junk bonds.

Senator SHELBY. What kind of limit do you propose? 10 percent? 5 percent?

Mr. ROHATYN. Probably less than 10. I would say 5, with diversification within the 5, and as I said, with different standards of fiduciary care, if you are buying this paper. You shouldn't just buy this paper because somebody calls you on the telephone. Furthermore, I think there are—to answer Senator Hecht's question, there are things the SEC can do very quickly to limit the abuses without getting to the issue of, can small companies sell junk bonds, which they should be able to, if they can't finance themselves any other way, but they shouldn't be abused in takeovers as a way to manipulate markets, which is what is happening.

Senator **Shelby**. Do you believe that we have sufficient criminal laws now, if they were vigorously enforced, as far as insider trading, that that would halt most of it?

Mr. **Rohatyn**. Well, I think if you enforce—if you send people to jail and to unpleasant jails, it will make a big difference. I agree with Nick that the definition of insider trading should be expanded in terms of collaboration, tipping, et cetera. And I think that is an area you probably should be looking at.

Senator **Shelby**. My time is up. Thank you, Mr. Chairman.

The **Chairman**. Under the rules, Senator Chafee is recognized.

Senator **Chafee**. Thank you, Mr. Chairman, I apologize for being late. We had a hearing in the Finance Committee at the same time.

Since I am not sure just what questions were asked, I would just start off with a fundamental opposition to a lot of these takeovers, and as Mr. Rohatyn mentioned in his statement about the greenmail payments made by Gillette and Goodyear.

VOTING RIGHTS

Let me ask you a question. What would you think if we passed a law that said that you would not have voting rights in your stock if you didn't hold it for 1 year? Would that be a—I would like to ask each of the gentlemen.

Mr. **Rohatyn**. I think, Senator, that is something that should be seriously considered.

Senator **Chafee**. Would you vote for it?

Mr. **Rohatyn**. I would vote for it. I think there is a fundamental difference between the interests of an arbitrageur who has owned the stock for 12 minutes and an institution that is supposedly in there for the long haul, and that the country's interests are probably better served by having investors with a long-range outlook voting on major restructurings, mergers, takeovers than people who just have been owning the stock for the last 12 minutes.

Senator **Chafee**. Would that solve the problem that I think you are addressing and Mr. Brady? I didn't see Mr. Cutler's testimony, but would that address the concerns you have, do you think?

Mr. **Rohatyn**. That would be just one piece, Senator. It would not, in and of itself, solve the problem, no.

Senator **Chafee**. Mr. Brady, what would be your reaction?

Mr. **Brady**. Well, I think the idea, Senator Chafee, is an admirable one. I get a little lost in the mechanics.

Senator **Chafee**. I think there would be mechanical problems.

Mr. **Brady**. Right. If you are talking—I mean, a lot of the stock that the arbitrage community holds doesn't go to a vote. It gets put into a tender. So if we disqualfied the vote on that stock, what would happen? Would the guy that bought the stock, would he be disqualified? I just get lost in the mechanics a little bit as to how you are going to get it done. I think the idea is right. I mean, the emotion and the sentiment and the concern are right. When you get down to how to write these things, it gets difficult, when you're trying to track it all the way through. When does the vote come back again? Things like that.

Senator **Chafee**. Mr. Cutler.

Mr. **Cutler**. I do think there are serious mechanical problems, Senator Chafee. In many of these companies, as much as 60 and 70 percent of the stock begins churning and getting sold in the market, and in effect, you've disenfranchised 60 or 70 percent of the shareholders for 1 year. And I think you might immobilize companies on matters on which they need majorities in order to make a merger, issue newly authorize stock, approve an option agreement, something like that.

Senator **Chafee**. I've got time for one more question.

What about another proposal that's been made that would impose a—you might even call a confiscatory tax on shares that weren't held for 6 months. That would be getting, I think, at some of the arbitrageurs and others.

What do you think of that one? Let's just say, 75 percent tax on profits of a stock that's held less than 6 months?

Mr. **Rohatyn**. Well, I wouldn't go that far, Senator. I would consider some kind of sliding scale of taxation on financial institutions that would go down with the length of holding period and would start with very short-term holdings, but I wouldn't suggest that it be a confiscatory tax. I don't think that would be appropriate. Well, 10, 15, 20 percent, maybe, but——

Senator **Chafee**. You mean above the regular tax?

Mr. **Rohatyn**. Well, a lot of these institutions are tax free. So it would be a nonexisting tax at this point. I think there ought to be——

Senator **Chafee**. Well, I wasn't thinking so much of institutions as I was of individuals.

Mr. **Rohatyn**. Well, individuals are going to pay short-term income rates anyway, and I think that in that area, I wouldn't touch it. I am concerned with the behavior of financial institutions that are supposed to be long-term investors. I mean, why do Japanese companies function with very high rates of leverage, is that they have institutional support in terms of their long-range policies and because of the leverage they take on is used to be invested in the business, instead of being paid out to the shareholders, is a very different issue.

Senator **Chafee**. Let me try Senator Brady now.

Mr. **Brady**. I agree with Felix, Senator Chafee. I think he is onto something in the last part of his comments. If you really want to examine something that would be useful, it would be why all of our money managers and the pension funds in the United States have gone so short term in their thinking. It really is a big difference, and it, of course, exerts enormous pressure on corporate managers, if they know their shareholders are going to disappear for another $15 on the stock, of course, they're going to cut their research and development costs and a lot of things that we worry about that go into our whole competitiveness as a country.

It is a very disturbing trend.

Senator **Chafee**. Mr. Cutler.

DEDUCTIBILITY OF INTEREST ON TAXES

Mr. **Cutler**. I think if you are going to look at the taxes, the tax here is the deductibility of interest on very highly leverage companies. If you reduce that, if you said that if you borrow money to buy stock, you cannot deduct the interest or the interest deduction is lower than it would otherwise be, you would see the end of the phenomenon very quickly.

Senator CHAFEE. Thank you. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Riegle. Senator Riegle has been very generous in permitting the committee to proceed before he made an opening statement. He has an opening statement. We all want to hear it. Go right ahead with it. Then your 5 minutes will start.

Senator RIEGLE. Well, thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. I am going to put my statement in the record. I know, serving, as I will be, this next 2 years as chairman of the Securities Subcommittee, that there is some interest in what we have planned at that level and how that fits with the work that's going forward here at the full committee level. I do have a statement in some detail this morning. I am not going to present it now, but it's available to anybody who would like to see it later, and it will go into the record.

As chairman of the Securities Subcommittee let me indicate my support for Chairman Proxmire's decision to hold this series of hearings on takeover issues at the full committee level. The importance of this issue—and the keen interest of all committee members in it—make this an appropriate subject to be considered at the full committee level.

As chairman of the Securities Subcommittee I look forward to working with Chairman Proxmire and all members of the committee is shaping whatever legislation we may produce in the areas thus far mentioned.

As this is our initial hearing on vital securities issues, I want to take this occasion to express some thoughts on related matters we will be dealing with as the year goes forward.

On the insider trading revelations, it is clear the SEC is continuing its investigation into the insider trading schemes of Dennis Levine, Ivan Boesky—and possibly others. I do not think we have heard the end of this story. Insider trading is improper, illegal and threatens public confidence in our capital markets. We must do all we can to prevent it. I think we must get all the facts before we reach a final judgment on corrective steps that may be needed.

In doing so, several issues must be examined.

First, our securities laws are based on the concept of fairness to all shareholders. Insider trading undermines this concept and ways must be found to put all shareholders back on a more even footing.

The practice of greenmail has been roundly and justifiably criticized and I have introduced legislation to restrict it in each of the last two Congresses.

Second, our securities laws are based on the concept of full disclosure. Like Senator Proxmire, I am impressed by suggestions that there should be more and quicker disclosure of certain securities transaction information. Fairness and full disclosure are cornerstones of our securities laws which enhance the integrity of our markets and lead to greater public confidence in them.

Third, I am concerned that the *Dennis Levine* and *Ivan Boesky* cases were discovered almost by accident. Dennis Levine was caught on the basis of a tip from Caracas, Venezuela and Ivan Boesky was caught as a result of his formalization of a kickback arrangement with Levine. What additional mechanisms, if any, should we put in place to facilitate the detection of such illegal activity in the future?

With respect to the Securities Subcommittee itself, our major responsibility is oversight of the Securities and Exchange Commission and the securities industry. In the near future the subcommittee will be reviewing the authorization of the SEC.

Prior to that time, I have scheduled the first Securities Subcommittee hearing for February 24, 1987. Securities industry leaders and leading practitioners will be invited to testify before the subcommittee on the following subjects:

One, how do we strike the proper balance between the role of government in regulation of the securities markets, and the industry role of self-regulation?

Two, what if anything, should the SEC be doing which it is not presently doing, and what improvements, if any, should be made in the regulation of the securities markets?

Three, does the SEC currently have adequate resources to do its job correctly; and are the remedies now available, adequate to deter securities laws violations?

I believe that the legislative process functions best when the private sector works closely and cooperatively with the public sector. The subject matter of the subcommittee's first hearing will be deliberately broad, and I would view this first hearing as an opportunity for members of the Subcommittee to openly question some of the leaders and practitioners in the securities industry regarding any of their concerns, and at the same time, to afford leaders and representatives of the securities industry the opportunity to make any specific recommendations and suggestions they think appropriate, and to testify on the topics already mentioned.

I anticipate that a thoughtful review of the issues raised and resulting from the testimony at our February 24, 1987, hearing will lead to other topics for further Subcommittee deliberations.

Other subjects of considerable interest to the subcommittee include the growing internationalization of our capital markets—and its impact on the competitiveness of our United States financial services industry, and developing a better understanding of other new market developments including program trading and portfolio insurance. Market volatility is something we will also consider.

Mr. Chairman, I look forward to holding subcommittee hearings which will complement but not overlap these hearings at the full committee level.

Finally, I want to say that I have enjoyed working with Senator D'Amato while he was the chairman of the Securities Subcommittee. He has worked hard on a number of the issues we will be considering today and he has introduced legislation which must be thoughtfully considered. I look forward to continuing to work with him—and am glad he plans to continue to be an active member of the subcommittee. I also want to welcome and look forward to working with the new ranking Republican on the subcommittee, Senator Armstrong, as well as the new Senators on the subcommittee—Senators Sanford, Shelby, Bond, and Chafee.

Senator **Riegle**. I want to go directly to two questions, so that we don't break the continuity of the exchange here, and I think the presentations from this panel have been very important. I think the recommendations are very important, and I appreciate the thought that they represent.

MORE COPS ON THE BEAT

Just quickly, with you, Senator Brady, you make it very clear that we need more cops on the beat and that you are willing to and urging us to spend more money to keep up the SEC, and so forth. And it seems obvious that that's necessary. What I don't understand is, you know, it seems to me that that recommendation comes awfully late. I don't find fault with you in doing it, but it seems to me, after a major scandal has broken, and that's the word that you used to describe it earlier, that it's one thing to say we need more enforcement. It seems to me, at the same time, that says we haven't had sufficient enforcement up until now, that we've had abuses taking place here that we were not following sufficiently.

I am a little troubled about the fact that, well, the SEC has come in and asked for more resources, since they heard about the scandal, for the last 6 years, they have not asked for resources. In fact, there's been sort of a casual attitude about that. And so it seems to me, that when you say more cops are needed on the beat, doesn't this suggest that we have had a problem here for some period of time that we just seem to be waking up to?

Mr. **Brady**. Well, Senator, I am not theological on this problem, and I think an analogy is, unfortunately, that when a crime rate goes up in a city, it doesn't offend me that we didn't have cops there before, but when we do have the crime, let's do something about it. So I can't disagree with your hypothesis. I wish we could have foreseen more of it. It's a hard thing to explain until you actually pin it down and get some some violations, but I think the main thing is, let's do it now.

Senator **Riegle**. Well, I am for doing it now. I guess, too, it is a question of how large is the size of the problem, and we don't fully know that, because even this insider investigation that is under way now, you know, the sense one has for it is, is that we have heard part of the story but not yet the full story.

Mr. **Brady**. Well, believe me, the problem is disappearing very fast. The Boesky-Levine affair, those things that the SEC has uncovered have been very instructive to the people in our financial community, some of whom are young, I think Felix will agree, and need this kind of instruction, but believe me, when you start putting people in jail and handing out stiff prison sentences, the bell rings. The light goes on.

Senator **Riegle**. Well, I think that there is a certain power to that logic. I don't know that we have handed out very many stiff prison sentences yet. Maybe that will be what follows. There's been some disgorgement of illegal gain, but you know, it remains to be its shares at $62.50 per share and finances the purchase with 12% junk bonds, its after-tax earnings on the remaining 4 million shares would rise from $5 per share to $7.50.[5] The increase in EPS does not arise from greater efficiency: the company's non-financing revenues and expenses are the same and its annual cost of capital (added interest payable minus dividends saved) has increased sharply before and after taxes. It arises solely from the tax arithmetic that drives takeover bids and defensive redemptions using junk bond financing.

A simple remedy would be to amend the Tax Code so as to eliminate or at least impose a percentage reduction on the deductibility of interest on debt issued to acquire more than a specific percentage (e.g. 10%) of a corporation's own shares or those of another company for purposes other than passive investment. Appropriate exceptions could be made for cases where the equity of the acquired company or the combined enterprise is not reduced as a result of the transaction, and for cases of new equity infusions by the owners of previously controlled companies.

Another possibility would be to deny interest deductions on that portion of corporate debt that exceeds a specified debt-equity ratio -- an approach which has an existing precedent in the "thin incorporation" rule applicable to loans by stockholders to their corporations.

A start in these directions has already been made by Section 279 of the Tax Code, which limits interest deductions for debt issued to acquire the stock of another corporation, if the debt is convertible and if the resulting equity-debt ratio or interest coverage falls below certain limits. That section as it now stands can easily be circumvented by issuing non-convertible debt. But the section could readily be tightened in the manner suggested above.

Elimination of this loophole would not only be consistent with the general objectives of the Tax Reform Act of 1986; it would also preserve the revenue base against the further erosion that will be inevitable if corporate income tax payments are reduced by a continuing equity decapitalization and a resulting decline in corporate equity-debt ratios.

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[5] See the attached calculation. More sophisticated examples and calculations appear in Cannelos, The Over-Leveraged Acquisition, The Tax Lawyer, Vol. 39, p. 91, along with similar proposals.

After-tax Effect of Purchasing 80% of a Company's Shares With Junk Bond Financing

1.	Assume earnings of	$170 mil BT
	Less Tax @40%	68
		102 mil AT
2.	Assume 20 mil shares	
	EPS - $5	
	Market Value at 11 x earnings:	$55
3.	Assume repurchase of 16 mil sh. at $62.50 with 12% junk bonds for $1 billion	
4.	Ann. Interest at 12%	$120 million
5.	BT Income	$170 mil.
	Less add. interest	120 mil.
6.	BT Income	50 mil.
	Tax @ 40%	20 mil.
7.	AT Income	$ 30 mil.
8.	Divided by 4 mil sh =	$ 7.50 p.s.
9.	Market value per share at 11 x earnings	$ 82.50

NOTE: The example assumes that the bonds would not be amortized but would be refinanced with new bonds before each maturity.

seen how hard the hammer is going to fall on anybody here and on how many people.

Let me ask you this question. You have all made specific recommendations, because you feel that the situation, as it is now, isn't sufficient and certain things need to be done to make it better, and I think your recommendations are very useful ones for us to have.

I am wondering, two things, how much damage has been done, absent the changes that you are calling for, and, if you take together both the damage that has been done and the prospect of what would happen if these changes that you are recommending were not to be made, what kinds of risks and jeopardies does that create for the economy in the future? Are we talking about an interesting small-scale problem here that we ought to do something about, but it is not a matter of great national urgency whether we do or don't, or are we talking about a matter here that cuts, you know, right to the heart of our economic future and something that we had better treat with some very high level of urgency and concern?

I would like to hear from all three of you on that.

Why don't you start, Mr. Rohatyn.

Mr. ROHATYN. Well, Senator, I think you are talking about a very fundamental issue here, which is the issue of investment allocations of the American economy and corporate behavior and corporate management. To the extent you allow a situation to continue which permits abuses on the takeover side and equivalent abuses on the defensive side, the result of which, in either case, is to overload companies with debt and reduce probably, probably, at least in many cases, their ability to compete in the future.

Then you are just leaving open a window and what will happen will depend on markets, maybe the activity will slow down for a while, but it will come back again.

So I see this as part of corporate governance, part of the investment strategies that this country is going to follow, part of the behavior of financial institutions, in terms of financing investment in this country. I think it is very important.

Senator RIEGLE. Would you say urgent?

Mr. ROHATYN. Yes, I'd say urgent.

Senator RIEGLE. Mr. Brady, what is your reaction? How serious a set of implications and jeopardies are we facing here, if we don't do the things that you and others have asked us to do?

Mr. BRADY. Well, I think it is in the area of serious to urgent. My concern, Senator, is that by doing some of the things that were suggested this morning, which, to me, are making the laws that we have on the books more explicit and changed in certain respects, so they work, you will get the job done, and you will remove the serious, urgent quality of what is going on now. It will work. The free market system, plus some specific changes that have been suggested. It will work.

Senator RIEGLE. Mr. Cutler, what was your impression?

Mr. CUTLER. I think it is very serious, Senator, primarily because of this decline in equity-to-debt ratio. When you get American industry down below 50 percent equity, down to 20 and 10 percent equity, as is true in many of these companies today, you are creating a situation in which everyone has to think for the short term.

You don't put money in R&D or in new plant, and you threaten the financial markets very, very seriously.

So you are all asking us to act, and I detect a high sense of urgency, basically, from all of you, saying that steps are needed now.

Senator RIEGLE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Riegle. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you. I apologize for being absent, but we have another hearing in the Finance Committee on catastrophic health insurance with Secretary Bowen. So I apologize to our panelists, and I hope I am not going to cover an area that has been overly investigated by my colleagues, and I am sure some questions have been asked regarding greenmail.

GREENMAIL ACTIVITIES

I would like to ask Nick Brady—Nick, as I understand your prepared testimony, you felt that essentially greater disclosure was all that was necessary in the greenmail area. Do I understand you correctly?

Mr. BRADY. That is correct. I think greenmail is an abuse that should be cured, Senator Heinz. The argument is to whether you ought to legislate it or not and how heavily, is critical. My suggestion is that you make anybody that is about to engage in greenmail, make them say how many shares they are going to buy, who they bought it from, why they had to do it, and once they have done that, let the process go ahead and complete the transaction with whoever it is and let the board of directors who authorized it be judged by the shareholders at the next annual meeting.

My feeling is that if they do it, they might get thrown out.

Senator HEINZ. One of the principles, and I agree with you, that you said we should use in evaluating all legislation, is protecting small shareholders. What you have described doesn't protect them; it just brings about the retribution on management after the fact. The damage has already been done. It strikes me that another alternative—and maybe someone has suggested it—is simply this: if a company is going to pay greenmail, it's got to pay it to everybody, and not just to the person seeking control. After all, the small shareholders have as much right to the control of the company as the person who is seeking control. What is wrong with that argument?

Mr. BRADY. Well, it is a good idea. I don't want to be trying to defend greenmail, because I don't believe in it, but I have a problem along the lines of how do we define it? In other words, when activity starts in a company stock and it goes from 20 to 40, the shareholders have the chance to sell along the way, it isn't total disaster from their point of view. There are times when companies can buy limited amounts of equity back and use their funds in that regard.

I have a problem of defining it accurately, and I think if you make people say ahead of time that they are going to do it, you will find enough furor so that it won't happen very often. Your idea is a good one too.

Senator HEINZ. Don't you have the same problem defining greenmail, if you opt for the disclosure route that you indicate, as well as with the suggestion I made? You are right. Companies do repurchase stock. They can do it on the open market. Most of them, I think, do. They can do it in blocks because they can get a little better price from that exchange, or they can buy off a corporate raider. I am not sure that the definitional problem, in terms of disclosure, is in any way addressed by your proposal.

Mr. BRADY. Well, my suggestion doesn't try and stop it. It just tries to let the investing public know what is going to happen before it happens. I say in my testimony, Senator Heinz, that this is the most difficult area that you fellows will have to face, and I must admit the suggestion I make is the best one I could come up with. I am not totally convinced it is the only one. I am not sure I am completely right.

Senator HEINZ. Let me ask Lloyd Cutler.

Mr. CUTLER. Senator, I think the best way to go after greenmail is to put the onus on the greenmailer. If you accumulate a block that triggers the Williams Act, why not have a rule that you cannot sell that block above market to anyone at any significant premium over market. That would end the practice right away. It is the fact that the man with the block can sell it to some other raider or some other company for 20 percent over the market which no other shareholder can get that drives corporations to buy the block back themselves.

And there are many cases where the independent directors of the corporations, who have no self-interest, honestly believe that the raider is going to wreck the corporation. I know of a case like this regarding a bank, where the raiders were simply not qualified to run a bank. They'd run another bank, and they had engaged in self dealing. Greenmail was paid, a slight greenmail. That bank is much better off today, and the share prices are much higher than they were when the greenmail was paid.

Senator HEINZ. Your suggestion is—oh, I'm sorry, Mr. Chairman. My time is expired.

The CHAIRMAN. Thank you, Senator Heinz.

Before I recognize Senator Graham, Senator Cranston has asked me to do something a little unusual. He wants me to put one of his statements in the record pertaining to this hearing. That is normal, but he also asked me to recognize a treasured constituent of his, Carol Ruth Silver. I hope Ms. Silver will stand, so we can recognize her.

Thank you, Ms. Silver, for being here. She has formed a task force on an independent Bank of America, and we are happy to have her here. Your statement will be printed in the record, Ms. Silver.

[The complete prepared statements of Senator Cranston and Ms. Silver follow:]

PREPARED STATEMENT OF SENATOR CRANSTON

I thank the chairman for getting an early start on the issues involved in corporate takeover. Takeovers have become increasingly important as our Nation's economy and financial markets continue to evolve. I hope today's witnesses have some useful guidance for us on these topics of concern. The issues we must consider are clearly not easy to resolve. They affect not only disclosure standards, but also raise questions about the conduct of corporate officials, the effectiveness of State laws on tender offers and corporate responsibility.

I would like to call to the witnesses attention a new player in the game of hostile takeovers: The First Interstate proposal to take over the Bank of America. I am concerned about the implications that a merger between these two banks would have on the competition in the banking industry. This is the first hostile takeover of a bank. Banks are the principal allocators of credit in our economy, they are federally insured and are the primary depository for the Nation's savings. Are banks different than other sectors of our economy? Should there be special rules against hostile takeovers of banks? I think we will soon have to face the question of whether we want banks, particularly troubled ones to be preoccupied with hostile takeovers, rather than with the safety and soundness of their institution over a period that could take from 3 to 18 months to resolve. Can any bank withstand the charges and counter charges that go on during the hostile takeover process without weakening confidence in the banking system or impairing that institution's ability to serve the public. This is a situation that many have feared. Now it is before us. I would appreciate the views of all the witnesses on this phenomena.

[The complete prepared statement of Carol Ruth Silver follows:]

STATEMENT OF SUPERVISOR CAROL RUTH SILVER,
SAN FRANCISCO, CALIFORNIA
TO THE
UNITED STATES SENATE BANKING, HOUSING AND URBAN AFFAIRS
COMMITTEE

JANUARY 28, 1987

WASHINGTON, D.C.

SUBJECT: THE THREATENED TAKEOVER OF BANKAMERICA CORPORATION BY FIRST INTERSTATE BANCORP

To Senator William Proxmire, Chair, and Senators Alan Cranston, Donald W. Riegle, Jr., Paul Sarbanes, Christopher J. Dodd, Alan J. Dixon, Jim Sasser, Terry Sanford, Richard Shelby, Jake Garn, John Heinz, William L. Armstrong, Alphonse D'Amato, Chic Hecht, Phil Gramm, Christopher Bond, Bob Graham and John Chaffee:

Thank you for allowing me to present these views.

Let me start with a riddle: what do the Golden Gate Bridge and Walt Disney's cartoon characters have in common? Answer: Neither would have come into existence if it were not for the willingness of Bank of America to take the risk and finance them -- when nobody else would. And Americans might not have seen the Treasures of China nor sent the San Francisco Symphony to Europe -- without the underwriting of the Bank of America.

I am here today as an elected representative of the people of the City and County of San Francisco as well as on behalf of a broadly based Task Force of San Franciscans. My purpose is to alert you to the fact that we -- not just San Franciscans but you and the people of all of the United States -- are threatened with the destruction of an institution which is a good institution -- not perfect, but good -- and one which has long, well and faithfully served the people of this small planet, in many nations across the globe, as it has also well served the people of the United States, the people of the State of California and the people of San Francisco.

The corporate culture of BankAmerica is one admired and lauded by charitable recipients, labor and local government across America for its concern not only with the bottom line of profit but with good citizenship. Its recent plaudits include Employer of the Year for Employment of the

Handicapped, being named First in Corporate Responsibility among Financial Institutions for three years running by Fortune Magazine, and being named by Business and Society Review the Most Socially Responsible Company in America.

BankAmerica has made some mistakes -- obviously -- or else they would not be in trouble and I would not be here. But I want to urge on you a proposition that goes well beyond the troubles of BankAmerica, and to which it is irrelevant whether San Francisco has a love affair with BankAmerica, despite its warts and wrinkles.

My proposition is this: that we, citizens of this nation, voters, workers, and consumers, have a LEGITIMATE INTEREST in bank mergers and acquisitions that we look to you to recognize -- now -- in ways that this interest has not been recognized heretofore.

Why, you may ask, should the perceived interests of shareholders be subordinated to our interests -- the interests of the general public? Clearly and plainly they should not be, and that is not what we ask.

Shareholders -- the owners through their stock -- of a major corporate institution such as BankAmerica -- have a financial interest in its merger or takeover. But we ask you to recognize also that there are others too who have a stake in the manipulation of these corporate assets, and

THAT THESE INTERESTS ALSO ARE LEGITIMATE, and that it is the responsibility of government to protect them.

The evolution of the law of ownership of real property in the predecessors of our legal system was FROM the absolute right of the Lord of the Manor, as owner of the land, to own, destroy, use and abuse every person and thing on, or attached to, his land -- TO a system where we recognize the RIGHT of tenants not to be evicted without due process, and where the public has a RIGHT to the maintenance of zoning and open space, and where even a trespasser has the RIGHT not to be enticed to disaster.

It is time for our government similarly to acknowledge and protect the interests of the public in the ownership of major corporate institutions. It is time that those institutions not be allowed to rise or fall in the uncontrolled pursuit of bigness for the sake of bigness, of hostile attempts at merger and acquisition justified only for the thrill of the chase and the battle -- and the hope of exacting vast tribute from a conquered tribe.

These activities in pursuit of acquisition and merger add NOTHING to the gross national product of the United States. In fact, Walter Hoadley, respected economist and a member of our Task Force, commented recently that in the past year the productivity of the United States had fallen by, he estimated, one full percentage point because of the diversion by "merger mania" of officials and executives of America's major corporations -- whether in plotting takeovers or defending against them. And another member of our group, a CPA who worked on the recent Safeway takeover, by a holding company with no business operations of its own, reported that during a three-month period the upper level of management of Safeway was forced to devote one hundred per cent of its time to the merger -- rather than to planning, managing and adding value to our lives.

The hallmark of upstream mergers and leveraged buyouts such as Safeway -- and the proposed First Interstate Bancorp takeover of BankAmerica Corporation -- is that a corporation enjoying the benefits of the economies of scale -- in terms of its purchasing power and its ability to subsidize its less profitable, developing divisions -- is replaced by a fragmented shadow of its former self. The acquiring entity argues that this is desirable: a white elephant managed by sleepy executives is to be replaced by an aggressive management -- unfettered by preconceptions and committed to creating a lean and mean business dynamo, in reflection of its original great history.

THIS IS A DEMONSTRABLY FALSE IMAGE. The company certainly is reduced in size immediately following the acquisition, but not to its benefit. By necessity the acquiring entity must incur LEVELS OF DEBT WHICH WOULD HAVE BEEN CONSIDERED TOTALLY UNACCEPTABLE TO THE FORMER MANAGEMENT BECAUSE OF THE CRIPPLING EFFECT OF THE DEBT SERVICE. In order to reduce this debt the new management must immediately generate cash and the only way to do that is sale of large segments of the acquired company. As with Safeway, the first segment to go is often the international operation, sold to local management or a foreign corporation. This immediately reduces the presence of American business abroad and ultimately contributes further to our trade deficit.

As the Company seeks to generate more capital, all divisions which have projected capital requirements must also be eliminated, either by sale or dissolution. The company is therefore no longer able to invest in America, to commit funds to project development or to finance less profitable divisions which are projected to achieve profitability only in the future. The acquired company no longer has the ability to wait for returns on investment as it struggles to meet its debt service requirements.

Many different segments of our society have a stake in this problem as it applies to the example of the takeover threatened by First Interstate Bancorp against BankAmerica Corporation, and most of them will lose enormously if it goes through:

Obviously the EMPLOYEES of BankAmerica Corporation will be hurt by the loss of jobs that will occur, hastening the evolution of the "white collar rust belt" amongst professionals and middle managers across America. The fifth largest metropolitain area in the United States, the SAN FRANCISCO BAY AREA, may lose economic vitality and its long term economic future will be placed in jeopardy.

CHARITIES will lose -- educational, cultural and civic institutions across the State of California and the world will lose an institution whose corporate culture has made it a major donor. The public record of First Interstate is that it has a lesser concern for charitable and social policy issues. (Under the Community Responsibility test mandated in the Commuity Reinvestment Act this element alone should give pause to any suggestion that the takeover of BankAmerica by First Interstate is good for America.)

CITIES, COUNTIES AND LOCAL DISTRICTS across California will lose. Bank of America has historically been the dominent public finance bank for their General Obligation bond issues, as a matter of public responsibility making the market by competitive bidding on virtually every public offering.

Other losers: Bank of America's SMALL DEPOSITORS -- as well as First Interstate's small depositors -- with insured savings under one hundred thousand dollars will lose convenience and the opportunity to enjoy creative new product offerings fostered by competition. LARGER DEPOSITORS, over the FDIC guarantee limit, would lose even more because they rely primarily on the reputation of their bank to assure the security of their funds, as do the holders of Certificates of Deposit, letters of acceptance, letters of credit, and other non-collateralized bank guarantees -- and the resultant bank holding company would be weaker, more leveraged, and LESS SECURE.

How could this be? How could this proposed new, bigger, combined bank holding company be less secure, less safe for depositers and borrowers than either BankAmerica Corporation or First Interstate Bancorp alone?

Because the enormous debt service that would be required by the proposed 3.2 billion dollar buyout of BankAmerica Corporation by First Interstate would result in an increased risk of failure of the new combined bank. More, it would likely result in a perception of increased risk by sophisticated depositors, thereby weakening the competitive position of the resulting entity. (Wayne Nicholson, a financial analyst who manages the reserves account for a local governmental institution in my

The **Chairman**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

In response to previous lines of questions, I gather that the basic position is that the junk bonds in and of themselves are not necessarily an evil, that the evil that exists is in the holder of those junk bonds, who does so under conditions that may be less that the fiduciary standards that we would expect those holders to exercise.

Is that a correct summary?

Mr. **Rohatyn**. Not quite, Senator. I think it is part of the problem. I think the other part is the use of junk bonds as a way of manipulating the market and creating takeover situations that might not be created without the ability to manipulate by making tender offers that are subject to financing that are simply based on a highly confident letter to finance with junk bonds and then followed by, in effect, the behavior of financial institutions. I have no problems with a company that doesn't have the credit rating, that needs to borrow money at high rates to finance expansion.

S&L'S HOLDINGS IN JUNK BONDS

Senator **Graham**. One of the issues that we are going to be dealing with and spent last week discussing in substantial part was the condition of America's savings and loan industry. It's been indicated that one of the significant holders of these junk bonds are these institutions. As we look at the question of recapitalizing the savings guarantee fund, what recommendations would you have as it relates specifically to those institutions and these type of securities?

Mr. **Brady**. Well, I think, Senator Graham, what Felix said earlier, a restriction on federally insured institutions owning more than some percentage. He said 5 percent—that seems fine to me—in junk bonds. Maybe even less than that. A counter argument is, speculative real estate and stuff like that that savings and loans get into now is even more damaging. So it is into kind of a definitional problem of what you are going to make hard to invest in.

Senator **Graham**. The junk bond phenomenon, as indicated, is a result of the last 6 years, is indicative of the sort of aggressive entrepreneurship of our economy.

Are there some suggestions that you might make that would deal with this issue of fiduciary institutions and their investment policy on a more generic basis, as opposed to looking specifically at what is today's problem?

Mr. **Brady**. Well, I can get as far as the very clear situation where you federally insured something. Going beyond that, I think probably puts restrictions on investment managers that they shouldn't have.

Felix, I don't know how you feel about it.

Mr. **Rohatyn**. Well, I think that, Senator Graham, one of the issues that might be worth looking at is requiring a higher standard of care and due diligence by money managers, who are usually indemnified in one form or another under the DNO insurance or some other provision, when they make investments that are advertised as being highly risk.

I am not saying that will solve the problem, but I think that is at least something worth thinking about.

The other thing, and again, I don't know that you can legislate, although you might—maybe some States might, but fiduciaries not hide behind the notion that their fiduciary obligation is to produce the very highest rate of short-term return, but their standards of performance in fiduciary obligations are long term rather than short term.

Senator **Graham**. Thank you, Mr. Chairman.

The **Chairman**. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Mr. Rohatyn, one of the most frequent arguments that are used by the hostile takeover entrepreneurs is that their activity is leading to a healthy restructuring of corporate America, that this is pushing us in the direction of a leaner, meaner, more competitive, if you will, corporate sector.

Now in your testimony, you indicate that this may not be the case, at least with respect to the energy industry.

I would like to ask you this question and also get the rest of the panel to respond. What is your reaction to these statements that this forced restructuring of corporate America through takeovers are on balance a strong plus for the Nation and on balance a strong plus for the economy. Does this activity push us in the direction of a leaner, meaner corporate structure? Are we weeding out inefficiency and those who are simply resting on past laurels, et cetera, et cetera?

Mr. **Rohatyn**. Senator, I have made my living for over 30 years doing mergers and takeovers, some of which have been extremely hostile. And as I said earlier, I don't differentiate between hostile and friendly. I differentiate between poorly financed and unfair. I guess the reason that I have been concentrating on the issue of hostile takeovers, it is in that area that I think the biggest abuses, with respect to corporate structures and debt to equity ratios have occurred, and in that area, the result, in my judgment, is very negative for the future of these companies, in terms of their being able to compete, in terms of their making investments in new product and R&D, et cetera.

So that it is in that segment of mergers and takeovers that I have very violent objections, and we don't participate in them. My firm doesn't sell junk bonds, represent raiders or any of that. And I think it is an area that gives me great difficulty, in terms of where I think this country ought to be going.

QUESTION OF COMPETITIVENESS

Senator **Sasser**. Well, I guess the question is, is it making us less competitive or more competitive, as some of the takeover arguments would indicate?

What do you say, Senator Brady?

Mr. **Brady**. Senator Sasser, I really don't think—I think the evidence is very, very incomplete and troublesome, because if we take the view that takeovers are making us less competitive, then there haven't been any takeovers in the automobile industry, and we are about as uncompetitive there as you can get, and I think it is over

30 percent of the cars sold in the United States are made outside this country. There have been very few, if any, takeovers in the steel industry, and we are getting our heads beat off by foreign steel manufacturers.

So I don't think there is any connective evidence that will support that point of view.

Certainly, the threat of takeovers and leveraged buyouts is something that makes this country's industrial machine leaner and meaner, as you say. I don't doubt that at all. And maybe some amount of research and development is deferred. However, you have the example of the drug companies where an enormous amount of research is going on, the market recognizes and these companies sell at values that make them takover-proof.

So I think the evidence is very, very mixed. I really do.

Senator SASSER. Mr. Cutler.

Mr. CUTLER. Senator, I agree with what has just been said. I do think there is one other aspect, though, and that is, I worry if lean and mean becomes the fashion and means you sell plants, you fire people, you incur huge debt, and you work over the short term just to get rid of that debt, that the social value of the corporation, the large publicly held corporation, as a steady employer, as a good corporate citizen, is going to be diminished, and if every company is owned by someone who is responding to all of these short-term values, I worry about the reputation of corporations and the business community in the United States.

Lean is fine but mean is not. Reliability, ethical conduct, steady jobs, communities, are all important social values, and it would be a terrible mistake, if we changed from maximizing long-term gain, which includes all of these other social values, to how much money can I make tomorrow?

Senator SASSER. Well, gentlemen, my time is expired, and I was just getting to the important question, Mr. Chairman, so maybe I'll have to reserve that for a later time.

The CHAIRMAN. Thank you. Senator Hecht.

Senator HECHT. I've already spoken.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman. First of all, I want to welcome this very distinguished panel. We are pleased to have all three of you with us.

I want to follow up on the question Senator Sasser put and the response, particularly, that Mr. Cutler gave, because as I sat here listening, we haven't really talked about the workers or the communities very much. And most of the remedies don't reach to their interests as I perceive it, and we have talked a great deal about the shareholders and all the people that are in the business of making money one way or another out of the takeovers, but it seems to me that there is a very important interest at the worker, the producer level and at the community level, which is, after all, the basic rationale for these economic organizations, in any event.

I mean, I assume they exist because at the productive level, they make a contribution, and if that is lost sight of, the fact that some people by manipulating it up at the financial level are making large amounts of money and still not performing a positive social value for the Nation.

On that score, let me put this question to the panel.

What is wrong about thinking of ways in which people move in to take over a company ought to be in it, to some degree, for the long haul? In other words, to operate that company and to take on the responsibilities of making a viable and profitable economic enterprise.

Mr. **Brady**. Could you give me an example, Senator Sarbanes?

RESPONSIBILITY OF CORPORATIONS TO THE NATION

Senator **Sarbanes**. Well, you would tie them in some way or other, so they couldn't just pop in and out. I mean, Senator Chafee had the idea you don't vote for 1 year. That's just one approach. I want to get from you a sort of a view on the general principle. If someone goes after a company, in trying to structure an arrangement, should you, in effect, start from the premise, well, if they are ought to take it over, well, then they ought to take on the burden of running the company. In other words, not manipulating that effort in order to come out with a big financial reward and then leave the company—in effect, dump the company or leave the company with these incredible financial burdens, which then affect the workers and the communities all across the country.

Mr. **Brady**. Well, first of all, I don't argue with your basic thesis at all. A corporation is many things. It has responsibility to its employees, to the consumers, to the community it lives in and maybe, lastly, to the shareholders. I wouldn't know how you would rate them. So I don't disagree with your thought that it ought to be a balanced response we come forward with. I have the same sentiment and emotion that you do, just walking in, in the name of a single dimension thought, which is more money for the shareholders, laying off a bunch of people. That doesn't appeal to me either.

My problem lies in the area of the fix, Senator. How do we fix it? And I think you do some of the things that have been suggested this morning here, you will see this slow down. I promise you, since the day that the Boesky affair came out, there has been an incredible decrease in this activity. It just is. The system is working.

Senator Sanford expressed my views. I don't think we need to replace the system. I think we need to do some very healthy and important tinkering, and you will see the result that you are seeking take place. I have no quarrel at all with the nature of your concerns. And your statement of the problem, I think, is dead accurate.

Mr. **Rohatyn**. I think, Senator, that what you might be able to do—and I think you saw in my testimony that I referred to this particular issue. I think that some States and some courts have held that the directors can weigh the impact on communities, employees, customers, et cetera, in reaching their decision with respect to a takeover. I think something along those lines, plus very broad disclosure required on the part of the person trying to take over a company as to his particular intention and keeping them to those disclosures, may be a way to go at the issue you are raising. It is very, very difficult.

Mr. **Cutler**. I would say, Senator, that most of the corporations you would identify as good corporate citizens have strong equity-to-debt positions, and that is equally true of the lean ones, the very successful ones, productive ones like the pharmaceutical companies, the computer companies, and so forth.

Don't make it easy, under the tax laws and under the margin laws, for those companies to turn themselves or be turned by someone else into companies with weak equity-debt ratios. That is the problem; it makes them mean.

Senator SARBANES. Well, that would deal with it at one level. How do you, at another level, deal with the idea people come in, and they want to take over a company. They say, we think we can run this company better than its existing management. We think they are inefficient. We think they are fat, and we think we can do a better job.

Now there is a strong economic rationale for that. They may be right or wrong, but there is an economic rationale.

Now I contrast them very sharply with someone who moves in to take over a company, paying the stock price and all the rest of it, and the greenmail possibilities and everything else, has no real intention of trying to take over the company and run it and make it a more productive enterprise or respond to the basic economic forces. He is simply in to try to rake over the financial return.

Now it seems to me there is a very sharp difference between those two. How can you draw distinctions between them, so that you can put a damper on this takeover effort simply for financial speculative purposes?

Mr. CUTLER. I think——

The CHAIRMAN. Before you answer, let me just say that Senator Sarbanes, as we all know, is a superb interrogator. He has asked a very critical question; however, his time is up. I am going to ask you to respond, if you possibly can, in monosyllables of one sentence.

Mr. CUTLER. I'll try in one sentence. I think the white hats will come in with equity. They will not debase the equity position. It is the black hats that are going to do that.

Mr. BRADY. My answer is, put the crooks in jail and change the laws in the ways that have been suggested this morning.

Mr. ROHATYN. I would simply join in that.

The CHAIRMAN. Thank you very, very much. Thank you gentlemen. This has been a very, very helpful panel.

I apologize for cutting things short, but we do have another distinguished panel that is coming up right now. We want to get them on the record too.

This panel consists of three people who have served with distinction on the SEC, including former Chairman Hills, who served from 1975–77, Mr. Sommer, who served in the Nixon administration, 1972–76, and Mr. Wheat, who served in the Johnson administration, 1964–69. We are delighted to have your wisdom and your experience.

I want to correct—while you are sitting down, I want to correct a misimpression I gave during my opening statement. This committee, if the chairman has anything to say about it, is going to start a markup on this matter this spring, just as soon as we can get the testimony from the SEC about the now pending cases involving Mr. Boesky and others. We expect that to be this spring.

Mr. Hills, go right ahead. You have—what is it 5 minutes—9 minutes. Go ahead.

STATEMENT OF RODERICK H. HILLS, MANAGING DIRECTOR AND CHAIRMAN, THE MANCHESTER GROUP LTD., WASHINGTON, DC

Mr. HILLS. Mr. Chairman, I do accept your view and that of members of the committee that some reform is needed in the process. The question to me seems to be whether the reform can be effected in a way that does not unduly interfere with the process of change in the scope and control of our economy. The process which Joseph Schumpeter said some 50 years ago was the essence of capitalism.

My own thoughts on this subject are very much influenced by personal experiences over the last 16 years as a director of six New York Stock Exchange companies and chairman of another troubled New York Stock Exchange Co. I twice suffered the sadness of having a fellow director engage in inside trading. Twice had to vote for poison pills. Twice participated in other companies to fight off hostile suitors, and two times I found myself reluctantly voting for a change in the state of incorporation, simply so we could erect defenses against hostile takeovers that weren't permitted in the State that we originally were in.

Once I voted to buy a major publicly traded company, only to find out that the four principal officers were truly major league scoundrels. Their thievery included insider trading that cost the company, our company, literally hundreds of millions of dollars.

And so I approach this subject in perhaps a more personal way, when I say that the reform is needed.

TAKEOVER GAME IS COMPLEX

The three observations I would have in a general fashion are these, that the takeover game today is a complex one. It has truly become a game for many people, a game that can cause terribly losses to unsophisticated people that are caught and cause losses to corporations that are unnecessarily damaged.

But I suggest that it is going to be difficult to civilize it. And I think it would be very much easier to do so, if you could approach the problem from the standpoint of not helping either the hunters or the hunted, but simply to seek simplicity for its own sake. There are some easy and obvious things that almost everybody would agree upon. Surely, the notice period should be shortened to 1 day. It is silly to have it longer. Parallel accumulation of stock by arbitrageurs, their friends and foreign investors is a very serious problem. The Guinness scandal in London is an example of that, apparently. Most of what Mr. Boesky is accused of having done seems to be the same.

I guess I would not move for restrictive legislation. I would simply say that the threshold of disclosure could be reduced dramatically, when people are engaged in something called parallel accumulation. I don't think it would be hard to define.

I think the committee should very well examine the question of whether corporations should be allowed to incorporate any place they want to, to switch back from State to State.

I think it can be done, and again, it could be very well considered.

I must say, however, that laws which would prohibit or rules which would prohibit specific techniques seem to me to be counterproductive, because the fertile minds that invented the techniques we have now, will just invent other ones. Greenmail, junk bonds, poison pills, they can all be adequately restrained. If we go back to the original focus that we have had over the years on the responsibility of corporate directors, which I will talk about in just a minute.

The one-man one-vote issue is a tough one. It seems to me that the notion that we can require one-man one-vote for all stock is illusory. We have never had that rule. To try to maintain it by law would be, I think, quite impossible. What we have today is a basically suitable corporate environment. It is a complex structure of State laws, of stock exchange rules and investor participation. And the real question is whether or not any substantial change should be made to shift that. Stock exchanges are now thinking of shifting their rules to get more customers. Now it seems to me that to encourage such a shift would be folly, but almost equally as bad, it would be to try to mandate a legislation to stop it.

The Commission, I think, has done a good job in jawboning the various parties. If this committee would add its own strength to that, I think corporate America might very much more appreciate the rules we have in force now.

Whether or not you could suspend the vote of shareholders for a while, as Senator Chafee suggested, seems to me problematical. Nobody is going to invest in a company that has bad management, if that management is going to be able to ruin the investment for 1 year. So you want to encourage the process of change in a helpful fashion.

Junk bonds have taken a lot of attention. I guess I think that you should look at junk bonds as only one manifestation of a more competitive world of financial services that has been evolving over the past 11 years. A manifestation that has permitted smaller corporations to have better access to capital at a lower cost, which has been, in many respects, the driving force behind the economy that after all has created more jobs per capita than any nation in recent time.

HIGH COST OF CAPITAL IS COUNTERPRODUCTIVE

The high cost of capital, more than any other single factor is why our industry is not competitive in the world.

My second point is simply that reform of the system should be concentrated more on focusing on the responsibility of independent directors and less on a series of complex rules that would make corporations even less flexible. Some say that it is hard enough to get directors already and some would notice that we have had enormous improvement in corporate governance in the last 10 years since the New York Stock Exchange has required independent audit committees as a condition of listing. But it seems to me that it is time to test the improvement, and it seems to me also that even the staff of the Commission could make some effort to deter-community, recently stated that the capital ratio of the resulting proposed First Interstate/BankAmerica entity would not meet his institution's capitalization standards for short-term investment.)

Approximately 1.6 billion dollars would be drained from the common equity of the proposed combination and from the U.S. Banking System as a whole. Although it is an obvious point, it may be worth stating: of the 3.2 billion dollars which First Interstate proposes to pay for BankAmerica Corporation, NONE of these funds accrue to BankAmerica Corporation. All of these funds would go to stockholders who will use them for alternative investments, or consumption.

Others who would also lose: LOAN CUSTOMERS of Bank of America and First Interstate would suffer from lack of competition between banks in their neighborhoods or towns across California and across the world's banking system. By virtue of the Wells Fargo/Crocker acquisition and this proposed acquisition of BankAmerica by First Interstate, eighty per cent of banking in the Nation's most populous state would be controlled by just three institutions. This concentration of banking services is likely, as any freshman economics student is taught, to lead to higher costs and lessened services to the consumer.

And we believe BANKAMERICA SHAREHOLDERS will lose. The First Interstate proposal is made up of an unusual package with three securities -- two of them junior securities. The market value of this package is speculative and may be less than the twenty-one dollar value placed on the package by First Interstate -- less than BankAmerica's current book value. Approximately 75% of BankAmerica's shareholders are the "little people" to whom A.P. Giannini loved to say his vast banking empire was dedicated. Although not certain, one may suspect in them a lesser sophistication, and the possibility of serious financial damage to such investors from holding junk securities -- such as an illiquid instrument of dubious marketability, evidencing 1/2500th share of preferred stock in First Interstate, with zero dividend the first year and unspecified fixed dividends thereafter.

Additionally, the long-run viability of BankAmerica's operations under First Interstate management is questionable given First Interstate's limited experience in running a bank of BankAmerica's size and complexity. First Interstate's banking expertise is different from that of BankAmerica: as to international banking, for example -- First Interstate has no experience in most of the foreign countries in which BankAmerica operates. Likewise it has less knowledge of the intricacies of correspondent banking, letters of credit and foreign currency transactions, and the many details necessary to operate in the specialized business of overseas banking. (I base these remarks and the statistics below on the research of Professor Larry Havercamp, of the Graduate School of Management, Golden Gate University, San Francisco.)

Thus, for these same reasons, the proposed acquisition is a danger also to the very SHAREHOLDERS OF FIRST INTERSTATE who believe that they have the most to gain from this takeover.

But the BIGGEST DANGER of all is to that entity MOST IMPORTANT of all -- so very important in fact that it has this august panel devoted to its preservation, regulation and management: the United States Banking System.

Permit me to give you first the executive summary of this point:

The First Interstate Bankcorp takeover of BankAmerica Corporation could bancrupt the FDIC because it is riskier than other bank acquisitions in several features: it is the first hostile takeover of a major bank in United States history; it is the most expensive proposed takeover of another bank in history; and First Interstate's proposals for financing the costs and reducing ITS risks of this

expensive takeover are, themselves, speculative and risky. The risks, therefore, accruing to the banking system, in this proposed acquisition, are likely to be greater than in any previous merger, takeover or acquisition within the banking system.

Financing the 3.2 billion dollar acquisition price will raise significantly the debt/equity ratio of the newly-combined BankAmerica Corporation and First Interstate bank. Even after selling off substantial assets as proposed by First Interstate, the combined BankAmerica/First Interstate equity/asset ratio would still be far below the average of the eight largest United States banks (3.6% vs. 4.6%). This results in substantially greater risk to the proposed combined BankAmerica and First Interstate entity than to most other banks, and greater risk than prior to the merger.

An additional source of capital infusion anticipated by First Interstate is from increased earnings resulting from efficiencies of combining BankAmerica and First Interstate. While some efficiencies may occur, the extent of such efficiencies is speculative. First Interstate estimates 475 million dollars in annual savings while BankAmerica Corporation estimates only 100 million. Should the BankAmerica figure prove more accurate, shoring up the weak capital structure of BankAmerica and First Interstate and reducing the risk attendant to this weak capital structure would prove very difficult. The huge cost of this acquisition cannot be paid for by the savings to be realized from the efficiencies to be achieved from the combination of the two institutions. The unusual nature and terms of the proposed junk securities is evidence that First Interstate itself has come to the conclusion that it could not successfully operate the proposed combined entity at a profit using conventional forms of debt to finance the acquisition.

These risks greatly increase risk to the Federal Deposit Insurance Corporation and the banking system of the United States -- with NO GAIN for the system. Should difficulties be encountered from this expensive acquisition, a resulting bank scare, or failure of the second largest bank in the United States, would likely result in bancruptcy of the FDIC and a greater shock to the United States banking system than anything experienced since the Great Depression.

In summary, the result of a merger of First Interstate Bancorp and BankAmerica Corporation would be a severely undercapitalized institution, the second largest banking institution in the nation, whose success as a business entity is not at all assured. Equity capital would be withdrawn from the banking system and risk increased. Many thousands would lose their jobs. A very few lawyers

and financiers would be greatly enriched. California would be the poorer and the nation would be the poorer.

Many will come before you to try to convince you that, in acquisitions and mergers, one plus one equals three. I am here because, at least for California, San Francisco and the United States Banking System, one BankAmerica plus one First Interstate equals, at most, one and a half.

Thank you for allowing me to share these views with you.

mine whether or not the independent audit committees that we have are as independent as we would like them to be.

I said before that I voted twice for poison pills. We did it reluctantly. We did it because we were told and warned that if we were ever to use those poison pills in a fashion that would thwart the takeover by an honest effort to give our shareholders more money, that we would very likely find ourselves in court defending ourselves to determine that we had, in fact, acted in the best interests of our stockholders.

If I had confidence that State courts would take that warning as seriously as some of us have taken it, I guess I wouldn't worry about it, but I have some concern today that the State laws are not sufficient. It could well be that a Federal standard of directors' responsibility exist. It may be evolving. If not, maybe it should be hastened by this committee. A standard that would say that a board of directors must have a sufficient independent quality to decide those corporate decisions that need that independence and that each board should leave that kind of decision to those directors that, in fact, have the requisite independence. If that standard was in effect, I think we would curtail the unfortunate use of techniques that has caused so much of our concern.

I don't like the idea of causing more litigation, but it is a far better approach than the restrictive rules that are going to make corporations more difficult in their competition.

Finally, I would just like to say that the frenzy of hostile takeovers is not the product of some new economic condition. It is only a more recent manifestation of a longstanding deficiency in the economic policies of our country, policies that have consistently caused corporate stock to be undervalued.

For reasons totally unrelated to junk bonds, we have increased our debt base enormously. In 1970, 10 cents of every corporate dollar of gross earnings went to pay debt, interest on debt. Today it is three times higher than that. It is a serious condition, because a debt-based society is not as flexible. It will not grow, and it will not innovate as much as an equity-based society.

The most visible form of our discrimination, of course, is the fact that we stubbornly persist in taxing corporate taxes twice. We discriminate in favor of debt and against equity. That fact is compounded by a system that constantly encourages consumption at the expense of savings. It is those economic policies that have been with us so long that has caused the American business community to pay a much higher price for capital than Japanese and German competitors, and it is those costs that have. for such a long time, caused stock to be underpriced.

When we correct those basic deficiencies, we are not going to have manifestations such as hostile takeovers, as much as we have had in recent times.

Mr. Chairman, it is whimsy and counterproductive to think that we are going to reach our eventual potential, our industrial potential, so long as we keep those policies in place. And so while there are a number of things that can be done, and I would like to say again, that it seems to me that the concentration on the responsibility of individual directors will help a lot. If we sue some more directors and put some more bad people in jail, I think we will be in far better shape rather than in trying to erect more restrictive rules that will make it more difficult for our companies to compete with their international competition.

[The complete prepared statement follows:]

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The Testimony of

The Honorable Roderick M. Hills

Before the

Committee on Banking, Housing and

Urban Affairs

United States Senate

January 28, 1987

Roderick M. Hills
Managing Director and Chairman
The Manchester Group, Ltd.
and
Distinguished Faculty Fellow
Yale University,
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As the Committe begins its deliberations on "hostile takeovers," I suggest that it keep clearly in focus the fact that this is not a new problem but is instead only the most recent example of a longstanding phenomenon of the American economy: its perennial and hopefully eternal ablity to change both its shape and those who control it. Joseph Schumpeter called this phenomenon the "essence of capitalism"; he referred to it as "creative destruction": a cycle of obsolesence, change, creation and obsolesence again. He predicted that capitalism would fall with the twentieth century as special interests combined to halt that process.

That his prediction is to date unfulfilled is a tribute to those institutions of our society that remain committed to preserving the very process of change that is now of such concern to this Committee.

I very much hope this Committee would agree with me and others who are reluctant to interfere with this process of change and would do so only if its destructive aspects seem to be more evident than its creative values. With that bias firmly entrenched in my mind, I reluctantly accept the view of Chairman Proxmire that there are reasons today to examine the process and a need to effect reforms that will edify it without unduly inhibiting it.

My present views are influenced less by my experience at the Securities and Exchange Commission and as a teacher and more by my experiences over the past eight years and between 1971-1975 as a director of six New York Stock Exchange Companies and as Chairman and Chief Executive Officer of another:

o Twice I have suffered with my fellow directors the sadness of learning that a fellow director had traded on insider information, once when we were purchasing another company, and once when we were selling our company.

o Twice I have voted with great reluctance to adopt poison pills to reduce the possibility that unwanted corporate suitors would acquire our company in a fashion that we might believe inappropriate.

o Twice, for different companies, I have participated in specific efforts, both succesful, to frustrate the efforts of a hostile suitor to acquire our company.

- On two other occasions I voted to change our state of incorporation because the laws of the new state enabled us to erect defenses not permitted where we were.

- Once I voted with my colleagues to acquire a major publicly traded company, only to learn that it was run by major league scoundrels whose thievery, which included insider trading, caused our company to lose literally hundreds of millions of dollars.

- Between 1971-1975 I wrestled with the wreckage of a New York Stock Exchange Company caused by my predecessor who made over 100 acquisitions during his tenure.

From these perspectives I have three general observations about your present effort to determine whether there is a "need to reform" the process by which "hostile takeovers" are launched and fought:

- First, the present "frenzy" of hostile takeovers is not the product of new economic conditions. It is only the most recent manifestation of longstanding deficiencies in the economic policies of our nation. To adopt remedies that are targeted to stop certain practices now in disrepute such as junk bonds, greenmail, poison pills and their like, would be tragically shortsighted. Such restructuring could severely reduce corporate flexibility and yet further divert public attention from the more fudamental issues. Legislative adjustment is appropriate now but the far more important focus of the Congress must be on longstanding deficiencies in our system. I will return to the subject later in my testimony.

- Second, the apparent performance of some boards of directors of public companies has caused many to ask whether these directors fully appreciate their fiduciary responsibilities to shareholders. Their willingness to pay greenmail, support leveraged buyouts, swallow poison pills and issue junk bonds may require a better articulation of what is expected of independent board members and a more specific insistance that corporate boards, at least of our larger publicly traded companies, have a sufficiently independent quality to deal with issues which require a judgement that is independent of management. I will return to this issue also. Let me suggest here only that "reform" should concentrate on making Board responsibility more clearly understandable rather than on producing more government rules that restrict corporate flexibility.

- Third, I have no doubt that an examination and some amendment of the legislative framework in which corporate takeover games are played is in order.

THE LEGISLATIVE FRAMEWORK

Let me begin with the third point. The present "takeover game" is played by rules so complex that only the most fertile minds can comprehend its finer points. Any lawyer or lobbyist who is on an arbitraguer team knows how exciting the battles can be. The moves in court and government are quarterbacked and executed by a highly paid legion of specialists who orchestrate corporate moves with the care and cunning of a chess grandmaster. Neither this committee nor the public should be concerned just because corporate officers seem all to willing to support a process that provides enormous income to young lawyers and bankers who execute these moves. However, the unfortunate truth is that too often less sophisticated shareholders are caught in the crossfire and occasionally sound companies are damaged or destroyed with an unnecessary loss of jobs and economic values, because of a misstep by a team leader.

It is therefore important for this Committee to examine the process with the Securities and Exchange Commission, as well as with the relevant self-regulatory organizations, to make certain that the complexities are reduced without unduly retarding the process. I shall briefly comment upon seven ideas to reform the process.

Notice Requirement: The ten day notice period now required of those who accumulate 5% of a company's outstanding stock is far too long in this era of electronic wizardry. Too many actions can be taken during this period to the detriment of companies, individual shareholders, and the reputation of our system. Whether the notice period should be one day or two days is beyond my expertise, but the need for shortening is apparent.

Some argue that all offers for a takeover, however tentative, should forthwith be communicated to shareholders. There is, of course, a risk that too much information on such subjects can be as dangerous as too little. For example, exploratory discussions by a potential acquirer could be frustrated because its own stock might be buffeted if preliminary inquiries to a number of potential acquistions were displayed. Nonetheless, it may be possible to improve disclosure in this area without undue damage to important commercial discourse.

At least it can be said that greater disclosure is to be preferred to greater regulation.

State of Incorporation: It would be timely for this Committee to examine the wisdom of restricting a corporation's ability to change its state of incorporation. A federal law that restricts a corporation's incorporation to a state in which it maintains a substantial part of its business enterprise would allow some flexibility in the corporation's choice of a "home state" but still restrict the sometimes shameless shifting of incorporation to protect against hostile takeovers.

Such a law would also have the grace of reinforcing the basic federal nature of our union.

Parallel Accumulation of Stock: Attention must be paid to parallel accumulation of stock by arbitraguers, their associates and foreign investors who have some reason to believe that a takeover is in the works. The Guinness scandal in England and stories about how Mr. Boesky operated suggest that this "technique" may be used too often.

I do not suggest that we adopt the discredited concept of "conscious parallelism" from the anti-trust field, nor do I believe that the definition of inside information should be extended to knowledge about the intended market activity of a fund manager. Other less rigid remedies can be designed. For example, disclosure of accummulated stock might be required at a lower level than 5% when the purchaser has reason to believe the same stock is being accumulated by one or more persons who anticipate that corporate control may change. As more and more stocks are traded world wide on different exchanges it is only sensible to adopt disclosure rules that can be effective under these changed circumstances.

Greenmail and Poison Pills: Other laws which would specifically prohibit or severely inhibit the payment of greenmail, or the prescription of a poison pill are not, in my judgement, appropriate or necessary, at least at this time. The use of greenmail and poison pills can be adequately restrained by a greater focus on the fiduciary responsibilities of directors without unduly restricting corporate action that has a legitimate economic function.

One-Man, One-Vote: The notion that we could impose a one-man, one-vote rule on all public corporations is illusory. For many years, and long before concern about hostile takeovers became rampant, corporations issued different classes of voting shares for good and substantial business purposes. To say now that it may never again occur would greatly inhibit the flexibility of corporate finance. We have today a suitable corporate environment created by a complex structure of state law, stock exchange rules and investor opposition. The issue before us is whether competing stock markets should be allowed to change their rules to secure new business and thus cause a radical shift in the ability of shareholders to inhibit inappropriate, selfish or careless corporate action.

To encourage such a shift would be sheer folly. Public acceptance of corporations and resultant legislative restraint is predicated today to some degree upon the leavening effect of shareholder democracy, however clumsy it may seem, and upon the presence of independent directors who depend upon those shareholders for their authority. If some part of corporate america is determined to escape those restraints, it will surely find the alternatives of tighter regulation that will surely follow, far more odious.

I have some confidence that cooler heads will eventually prevail and that a decent accord will be reached that will neither abandon the present environment nor unduly restrict legitimate changes in voting structures. The "jawboning" efforts of the Commission on this matter are to be commended. This Committee's support of the same philosophy would greatly strengthen corporate appreciation of the present rules.

Junk Bonds have been too often the subject of scorn and legislative inquiry. As I will attempt to demonstrate later in this testimony, the deficiencies in our economic system are far more fundamental than the current vogue now enjoyed by junk bonds. More important, junk bonds are but one manifestation of a more competitive world of financial services. That smaller corporations have better access to capital at a lower cost is an important driving force for an economy that has produced more jobs per capita in recent years than any civilization of modern times and one that has done it in a period that Western Europe has had an absolute loss of jobs.

In this country those jobs have come mainly from the smaller companies who are aggressively competing world wide with more entrenched enterprises. The worldwide revolution in the capital markets should be credited with this success and not restrained by narrow visioned regulation.

We can look here also for more responsible independent directors to curb the improvident use of junk bonds as a "takeover" technique.

Summary: The effort to civilize the rules of the "takeover game" will not be easy. That it is wasteful and savage as now played results from so many different reasons that any set of short term reforms may be counterproductive and could well be frustrated by the same inventiveness that have brought us to the present state.

As the Committee begins once again to study the subject it would be helpful for it to adopt the philosophy that it does not wish to help either the hunters or the hunted. The ineffectiveness of the Commission, the Courts and the Congress in the past has been often caused by a perceived need to help one side or the other in specific circumstances.

If this new reform effort could be dedicated to a pure search for simplicity, a better result may well be reached.

One final observation may be in order. Of the industrialized countries, only ours leaves control of publicly traded corporations so freely to the marketplace. That Japan and Germany severely restrain hostile takeovers does not mean they should be emulated. Rather we should appreciate that Schumpeter's "creative destruction" is a real strength of our economy.

If we do wish to create a restraining influence I suggest that it be placed with independent directors and not with any government or quasi-government agency such as London's takeover panel. However, as will be seen from the next part of my testimony, directors who receive and exercise such authority should necessarily have a far greater personal responsibility to stockholders to protect the value of their shares.

CORPORATE DIRECTORS

It may seem untimely to some to call for greater responsibility for corporate directors at a time when insurance is difficult to secure for them and when some say that it is hard enough already to find good directors. Also, it would surely be unkind not to pay respect to the considerable improvement in corporate governance that has occurred in the ten years since the New York Stock Exchange required that independent audit committees be a condition of listing on the Exchange.

Nonetheless, it is time to appraise that improvement in objective terms. Are members of audit committees as truely independent as we believe they can be? Who selects them? Does the board yield entirely to the dictates of the Chairman who calls in old friends or is real care taken by existing directors to make certain that those who are chosen for audit committee roles have, as a practical matter, the capacity to independently judge the quality of management and the unselfishness of their decisions?

The evolving law of directors' responsibility could use some high level testing. Arguably, the Securities and Exchange Commission could challenge the integrity of audit committees that are lax in their monitoring of the disclosure process. If so, the formidable talents of its Enforcement Division could be encouraged to bring a few noteworthy cases.

I mentioned earlier that I twice voted reluctantly to adopt poison pill defenses to hostile takeovers. On both occcasions my fellow directors and I were uncomfortable. The potential destruction latent in that weapon seems so out of place in a sensible corporate environment. However, on both occasions we were carefully warned about the personal danger to each of us if we should decide to use it. If its use thwarted an honest effort to buy our company at a premium over market value, we were told that we would likely be required to explain in court why our action was in fact in the best interests of our stockholders.

I believe we take that warning seriously, but I seriously wonder if a state court examing our conduct would judge us by the same standards that we believe we will use if put to the test.

It could be that a federal standard of director responsibility is evolving out of practice: a standard that says that each board of directors must have a sufficient independent quality to decide those corporate decisions that need such independence, and that each board must leave that kind of decision to those directors that in fact have the requisite independence.

There is considerable legal precedence to test such a standard. The boards of investment companies have long been required to have "independence" when setting the fees charged by those who manage the assets of mutual funds. Also, when boards of directors seek to dismiss shareholder lawsuits against management on the basis of their "business judgement" many state courts inquire deeply into the question of whether the independent quality of the directors making such an effort is sufficient to entitle their "business judgement" to the respect of the court.

If my rationale is sound, it may be said someday that any board of directors is per se negligent if it does not equip itself with members able to make such decisions when and if the occasion to do so arises. A quicker way to reach that result would be to determine whether independent auditing firms are refusing to take corporate assignments before determining that the audit committees of the boards of prospective clients do have the requisite independent quality. After all, how can the auditors discharge their obligation to deal properly with questionable management practices if there is no independent faction on the board to which they can appeal?

If this Committee should conclude that auditors do not make such pre-engagement inquiry, then the auditing standards of the profession could be revised to be certain that they do so in the future.

I confess a considerable personal reluctance to have any action taken that could promote more litigation or make it more difficult to secure competent directors. Nonetheless, I believe that boards staffed with the kind of independence I describe will effectively curtail the improper use of greenmail, poison pills and junk bonds.

More important I am certain this approach is far preferable than one mandated by this Congress which would proclaim with rigidity what can and cannot be done by corporations mixed up in a takeover fight.

DEFICIENT ECONOMIC POLICIES

Finally, I wish to speak about the more fundamental reasons for the current unease about corporate behavior in the "takeover" arena and about the worry we all have that it may adversely affect our economy and particularly our international competitiveness.

For many reasons, that are totally unrelated to junk bonds and the current explosion in the number of other financial instruments now available, we have increasingly become a debt based society rather than the largely equity based society of several decades ago. In the 1960's, approximately ten cents of every dollar of gross earnings of American corporations was used for debt payments. Today that figure is three times as high.

Why is this a serious condition? It is serious because a debt based society is far less flexible and far less likely to grow than one that is equity based. Debt must be paid back. Lenders, even foolish ones, impose restrictions on those who borrow. No responsible management can take the kind of chances with debt capital that we expect them to take in an innovative fashion with equity capital. Dividends can be suspended if corporate plans go awry. Only bankruptcy can relieve a company from its duty to pay interest.

As I suggested earlier, the very essence of a capitalistic society, particulaly the one which we have today in America, depends upon the kind of innovation and growth that only equity capital can produce. Joseph Schumpeter said it well and best many years ago:

> "Feudalism is necessarily a static economy.
> Socialism can be and often is a static economy,
> but Capitalism depends for its very existence
> on innovation and growth."

What have we done? Simply stated, we have for too many years discriminated against equity capital in favor of debt capital in too many ways. What we have done is far more discriminatory than the practice of any other free enterprise industrialized society.

The most visible form of our discrimination is our stubborn insistence that corporate profits must be taxed twice, once at the corporate level and again when dividends are paid to stockholders. Interest paid on debt reduces taxes while dividends paid to real investors who intentionally take risk are taxed again.

It is instructive to note that each President since Richard Nixon has, at the start of his term, called upon the Congress to redress this wrong but in each instance their original crusade has lost out to shorter term political compromises.

This persistent discrimination against equity is compounded by a legislative and regulatory framework that constantly encourages consumption at the expense of savings. It is no mere coincedence that our competitive posture in the world is seriously threatened by the Japanese and German economies which enjoy saving rates two and three times greater than our own. Each of our recent Presidents has also proclaimed the virtue of saving but in every economic confrontation with Congress the short term political benefits of a consumer led recovery overcomes the sober reality that our longer term best interests will be better served by a higher savings rate.

The survival of these economic policies has over the years kept the cost of capital to American firms markedly higher than that paid by our international competitors. It is easy and perhaps even appropriate to call for tougher trade policies and better management. No doubt there is merit in both points. But it is whimsey to believe that we will ever reach our industrial potential so long as we shy away from correcting the fundamental deficiencies in our economy that have plagued us for far too long.

At this point, a member of this Committee reading my remarks may be thinking:

> "Well we can't do anything about
> that right now. We are exhausted
> by our struggles for a new tax bill
> and to overcome budget deficits.
> Apart from those issues, what can
> you suggest that we should do?"

If so, recall that old saw:

> "Apart from that, how did you like
> the play, Mrs. Lincoln?"

If upon sober reflection, you conclude that it really is not timely to address these more fundamental matters, then it is important to accept the fact that your legislative alternatives are limited. The radical legislative ideas now advanced by some can only further hamper corporate growth and ingenuity and thus put our industry at further competitive disadvantage.

Eleven years ago the American Assembly gathered 29 prominent economists, over 20 corporate financial officers, a half dozen financial writers and a couple of government officials at the magnificent Harriman House to discuss the problem of capital formation in this country. With remarkable unamimity they concluded:

> "Current tax policies result in
> ineffeciencies in the allocation
> of capital. Regulation that distorts
> prices curtails investment.
> Inflexibilities imposed by law in
> financial markets cause misallocations
> of saving."

> "We must design our regulatory
> policies, tax system, and financial
> market policies in ways that reduce
> impediments to investment."

At about the same time President Ford began a broad bipartisan effort to rationalize economic regulation of business, an effort carried on by President Carter that may still have some vitality in the present administration. Nonetheless, the observations of 1976 made at Harriman House are, sadly, just as relevant today.

The **Chairman**. Thank you very much, Mr. Hills.

Mr. Sommer.

STATEMENT OF A.A. SOMMER, MORGAN, LEWIS & BOCKIUS, WASHINGTON, DC

Mr. **Sommer**. Thank you very much, Mr. Chairman.

Mr. Chairman, members of the committee. First of all, I would like to commend the committee for taking on this topic so early in the session. I think it is a critical one. I think it is one that the Congress might well address in some depth during the days to come, and it is obvious that you intend to do that.

I am going to talk about some rather basic propositions, and I think they were foreseen in a way by the dialog between Senator Chafee and the previous panel.

It started, I think, with the question of what we expect of our American corporations. The American corporation is a great engine, if you would, that has resulted and will result in the creation of tremendous amounts of wealth, if it is properly handled, treated, and protected. It has been the means for enriching the lives of innumerable people in this country, providing jobs in unheard of numbers, enriching communities and providing wealth for all of us.

OPPORTUNITY TO PLAN ON LONG-RANGE BASIS

In order to do all this, management must be given the opportunity to plan on a long-range basis, to lay out plans for the development of products, to make commitments and capital expenditures that may be 5, 10, 15 years in being realized.

These are the things we expect of our corporate management and which we need from our corporate management, if they are to do the job that they have historically done.

Now, 55 years ago, Berle & Means in their book, "Private Property and the Modern Corporation," described a dichotomy that had developed over the years between the owners of corporations and those who managed them. Now many people construed that as being a criticism, but in fact, Berle & Means said that dichotomy was an advantage, because the result was that the managers were the people who were competent to run the affairs of the corporation while the owners were not necessarily so, and because of their numbers, were inherently incapable of doing it.

Now the benefit that derived from that division was predicated upon an assumption, and the assumption was that the shareholders had the same long-term interest in the corporation and its future and its welfare that the managers had. What has developed now is a new dichotomy. The managers feel impelled and are required, in fact, if they are to do their jobs, to devote themselves to the long-term interests of the corporation. However, a substantial portion of the investing population has come to have what I call the philosophy of the now generation. That segment of the investing population demands that it have profits immediately. Rather than get profits as a result of dividends and growth in the price of the stock over a period of time, these investors want to have their bird in the hand right now. They don't want any birds in the bush whatsoever, no matter how promising they may be.

The corporation is made up of many constituencies that must be taken into account, as Senator Sarbanes said. It is essential that these have a forward-looking, long-term philosophy. But many institutional investors want profits now because they need them in order to justify their continued control of the funds they manage. I criticize not the institutional investor because of their attitude. They are driven to their attitude by other forces. Why do they need that? Because without it the institutional investor is likely to be replaced by other managers who have a better performance record. So performance is the name of the game. If a portfolio company is taken over, a handsome premium is paid for the stock and the institutional investor is able to show in his portfolio a handsome gain.

Now what is the consequence of this? The consequence of all this is that there is a tremendous incentive for a would-be entrepreneur to come in, make a bid, put a company into play, send up the price of the stock, and then either sell out, along with those arch opportunists, the arbitrageurs, or take over the company using junk bonds, pay off the shareholders, then sell off big parts of the company, regardless of what the effect that may be upon the long-term prospects of the company.

Thus, any company that is selling today in the market for less than what someone thinks might be realized if the company were broken up and highly leveraged is a potential target for a takeover. And with that in mind, the management of every company in that position is looking over its shoulder, concerned that somebody is going to come in and try to take the assets, try to take the business, regardless of its employees, regardless of communities, regardless of any obligations whatsoever, try to realize the maximum benefit in hand, right now, for the shareholders.

That is the danger that exists. And very often, as a corollary of that, managements themselves, who see themselves in peril or hear rumors that they are going to be the target of a possible takeover, are often impelled to undertake actions actions on their own initiative to provide big immediate payoffs to shareholders, in order to provide an immediate bird in the hand, an immediate buildup in profit to their shareholders.

Where does this demand come from? It comes from, as I say, the "now" generation. The notion is that the purpose of a corporation is not the long-term welfare of the community or its employees or its shareholders, but rather is to be a pawn to be utilized in a fashion that will be most profitable and most beneficial to the shareholders that exist at a given moment, regardless of the length of time that they have held stock in the company.

PROGRAM TRADERS

The very quintessence of this short-term perspective that has become prevalent in the market is seen in program trading. Program traders buy stock for an hour, a day, a week, with no concern whatsoever about the corporation. They buy it simply so they will have in hand a pawn with which they can play this deadly and profitable game with index options.

Once the company is in play, usually the company's fate is sealed. Either it will be broken up by outsiders for the purpose of immediate profit, or the management itself may be impelled to undertake destructive actions in order to meet or match, in some fashion, what appears to be the offer of the outsiders.

Over the years, virtually every defense that management has had against the possibility of a hostile takeover and a breakout has been taken away from them, other than duplicating the very action that the would-be offeror would take himself. Consequently, the corporation stands stripped and unable in any fashion effectively to fight off a takeover it regards as inimical to the interests of all of those who are constitutents in the corporation.

The assertion is made by some that there should not be any interference with the transfer of control. These people, in my estimation, regard corporations, as two economists in favor of that position have said, simply as apples to be traded freely like a commodity, like a gem, like anything else, without any concern whatsoever for the fact that people's lives are involved with them, long-term investment relationships are involved with them, communities are involved with them, suppliers are involved with them, customers are involved with them. They are not simply apples. They are living, breathing components of our economy.

Finally, the argument is made that unless you have takeovers, you simply have no discipline available to assure that management will do its job. I would submit that is nonsense. There are plenty of disciplines, including outside directors, which Mr. Hills has referred to. You have the media, which are constantly exposing the ineptitudes of management. You have institutional investors who are quick to make known any hostility they may have to the quality of management. You have the banks, which certainly make known to their customer, when they think there is an inadequacy in management. And you have the market itself, which quickly signals management when it is not doing its job.

There are plenty of watchdogs assuring that management performs its role properly.

If we are engaged, Mr. Chairman, in a struggle for competitiveness throughout the world, I would suggest it is not without meaning that the Japanese and Germans do not permit takeovers in the fashion in which we have them here. Thus their companies are free to do long-range planning in the interest of their economies and the communities which depend on them without the necessity of looking every moment at the stock market to make sure that their stocks are performing in a fashion that would preclude the possibility of a takeover.

Mr. Chairman, this Congress has an opportunity to put an end to these ruinous activities and to free American business to focus its entire attention on the job it must do to make it competitive in the world market.

I suggest to you there is probably no more crucial domestic issue before this Congress.

Thank you.

[The complete prepared statement follows:]

TESTIMONY OF

A. A. SOMMER, JR.

BEFORE THE

BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

OF THE UNITED STATES SENATE

January 28, 1987

My name is A. A. Sommer, Jr. I am a partner in the law firm of Morgan, Lewis and Bockius, in Washington, D.C. From 1973 to 1976 I was a Commissioner of the Securities and Exchange Commission. Since leaving the Commission my practice has been exclusvely in the corporate and securities area, and in the course of it I have counselled corporations frequently concerning tender offer matters and have represented groups with interest in tender offer legislation and related matters. However, my appearance before you today is totally personal, and the opinions I express are strictly my own and do not necessarily represent those of anyone other than myself.

I would first like to commend you, Mr. Chairman, for your initiative in beginning these hearings so promptly after the convening of the 100th Congress, particularly after your diligent efforts to achieve tender offer reform in the last Congress foundered, I believe, on the failure of a sufficient number of your colleagues to realize the enormous importance of the takeover phenomenon to the economic well-being of the country. I earnestly hope that your efforts in this Congress will command the attention and breed the action that is so desperately needed.

Fifty years ago Adolf Berle and Gardner Means published their seminal work, The Modern Corporation and Private Property. In this work the authors described in fascinating detail the way in which the necessities of modern capitalism had caused the separation of ownership of the corporation and its assets from control over the use of those assets for productive purposes. The authors described how historically ownership and control had been combined in a single person or persons, an arrangement obsoleted by the need to raise large amounts of capital and the need to manage them most efficiently.

Berle and Means did not deplore this. They recognized it for what it was: a necessity. And they found in it merit: it resulted in vesting control in the hands of those more competent to manage since mere ownership of stock in a corporation gave no assurance of competence to manage it, and besides it was clearly impossible for the thousands upon thousands of shareholders of the modern corporation to manage actively their enterprise.

The managers, those who control the use of the corporation's assets, are constrained by fiduciary principles to conduct the affairs of the corporation for the benefit of the shareholders and not for their own benefit.

This dichotomy between the owners of enterprises and those who run them persists, of course. This differentiation, which Berle and Means saw as good and efficient, has now turned ominous, and instead of a congruence of purpose between shareholders and managers we are now witnessing the development of a vast and harmful gulf between them. This gulf, very simply, is this. We want managers to manage for the long pull -- undertake research and development projects, make capital commitments, develop five year plans, preserve the integrity and future prospects of the enterprise. On the other hand increasing numbers of shareholders are being encouraged to demand that they receive the maximum values latent within the corporation here and now with no regard for the means used to provide them or the effect this may have on the long term destiny of the corporation.

This gulf has been created in large measure by the advent of the hostile takeover. The practitioners of the takeover art have spread the notion that if the market price of a stock is less than the amount that could be realized by selling off some of the corporation's assets and leveraging heavily what remains, that is an indication of an inept management that should be ousted, and they are quite willing to be the avenging angels that achieve the ouster and bring about the breakup and liquidation.

One doesn't have to dig hard to see the absurdity of this theory. The stock market essentially values a hundred shares. It is axiomatic that it never has and is inherently unable to value the value of a company as a whole and as a going concern or in liquidation. If indeed the stock market were a true measure of management performance, then we would have to conclude that the management of New York Stock Exchange listed companies today is about 15% more competent than it was near the end of 1986 since the Dow Jones has increased by that much since then, and we would have to believe management is four times as good as it was in 1975 when the Dow Jones average was a quarter of what it is now. This is, of course, absurd: the stock market reflects many influences and by no means is it an accurate measure of management skill.

The notion is spread by practitioners of the takeover art that shareholders are entitled right now to the top dollar their company will bring, whether that be in the stock market, or as a consequence of a restructuring that piles up mountains of debt, or through the sell-off of units that may bring more than their here and now contribution to the earnings of the enterprise. This is a new manifestiation of the "now" generation that is unable to defer gratification and wants all the satisfactions of life immediately.

I know of no study of this question, but I would guess that a person could find among the stocks listed on the New York Stock Exchange today, even after the recent run-up, many, including a number of excellent, well-run companies that are contributing enormously to our economic well-being, that could be restructured with massive debt or broken up and sold in fragments to give shareholders more than the present price of the stock. If, as the takeover practitioners assert, the obligation of management is to assist shareholders in realizing top dollar for their company today, then the managements of every company in the country that would provide more immediate benefit to its shareholders if it were put on the auction block should undertake to do just that.

In short, it is not enough to run a business for the long term, to seek to realize the values latent in the company's capital assets, its management, its employees, its research and development, and its carefully laid plans, if greater instant gratification can be afforded shareholders by other means.

The tender offer practitioners find an eager audience among an increasingly large segment of the shareholder population, the institutional investor.

The ownership of American corporations is increasingly concentrated in large, sophisticated institutions which manage a trillion dollars of pension funds, billions of dollars belonging to charitable organizations and to wealthy individuals. It is estimated that well over half of the shares listed on the NYSE are in the hands of institutions, and that over 40% of securities listed on the NASDAQ/NMS, a market that until recently was largely ignored by institutions, are now in institutional hands.

These institutions, with too few examples, are short term in their orientation and many of them are players in the programmed trading activity that in the judgment of many market experts has done much to bring about the unprecedented instability in the market that we are witnessing.

Institutions trade far more frequently than individuals. Since much of the institutional money enjoys some sort of tax advantage (e.g., pension funds and charitable funds are not subject to tax) there has not been any incentive for them to hold securities long enough to realize long-term capital gain. Most of them are under intense pressure from some quarter -- boards of charitable and eleemosynary institutions, employers which select them to manage their pension plans -- to show consistently superior performance, regardless of the means needed to do that.

These investors have no long term interest whatsoever in the corporations in whose securities they invest. They do not invest with the objective of profiting from the realization of the long term plans of management. Their sole interest in the securities in which they invest is the potential for rapid realization of profit so their performance looks better.

Program trading, of course, is the quintessence of short term investing: stocks are bought to be held a few days or a week simply as tokens to be used in playing games in conjunction with the stock index futures. There is not a whit of resemblance between these in-and-out traders and traditional shareholders who purchase stock in a company with the expectation that gains in

dividends would be their long-term rewards resulting from the comptence and good judgment of management.

This short term orientation of most institutions, of course, translates readily into a corresponding attitude in the management of companies with securities in the portfolios of such investors. Well aware of the desire of those holding significant amounts of their stock for quick profits they use all sorts of means to minimize the danger of a hostile offer which would push these huge amounts of stock immediately into the hands of arbitragers, and thus seal the fate of the company as an independent entity.

Contrary to the propaganda of those who don't want hampered their right to buy companies and tear them into bits without concern for their long-range prospects, the competence of management, the concerns of employees, communities, suppliers, customers, most managements do not resist unnegotiated takeovers to entrench themselves. They do it because -- and rightly so -- they don't want to see the values inherent in their company, the long-term gains that will accrue from the continuation of it as an independent entity, the interests of the company's many constituencies, wantonly destroyed by an invader concerned only with immediate enrichment. Any management with faith in itself, a long-range plan it believes will benefit the company and its constituents, a commitment to continuation of the enterprise as a producing part of the American economy, is a target for the charge of "entrenchment" if it tries to ward off the destruction of all that. That charge is as unfair a one as has been made against business in my lifetime.

Notwithstanding my belief that this short term orientation of an increasingly dominant type of investor is harmful to the economic and social good of the country, I would not fault the institutions. They are in an extremely competitive business. Like the sports team, their scores, their successes, their failures are very visible, and those who review their performance are quick to note when they fall short of the performance of other managers or of the S&P 500 or the Dow Jones Industrials. Consequently, there is built into the investment scene a huge incentive for emphasis on short term results.

The prospect of immediate profits and immediate boost to performance record drive the institutional investor into the hands of the arbitrager or offeror. A subtle form of coercion does the same for many individuals.

It has been common to refer to two-tier offers as being coercive. I submit all tender offers are coercive, including those bids that are for all shares and for cash.

A shareholder confronted with a bid for any and all shares for cash is necessarily under considerable pressure to tender. Unless the offeror has indicated that he will do a "clean up" merger upon completion of the tender at the same price as that in the tender, the shareholder does not know if he will ever be able to realize as much for his shares as he could in the tender. He must assume that enough holders will tender to afford the offeror control, hence unless he tenders he will likely be at the mercy of the offeror, perhaps without a liquid market for his shares, and in any event the market price will be lower than the offer price. If he is uncertain about the quality of management the offeror will bring to the enterprise, he may be left with the choice of remaining a shareholder in an enterprise managed by people in whom he has no confidence or selling his stock after the tender at a likely lower price. Even if there is assurance of a "clean up" merger at the tender offer price, there may be a delay before he can get his money if he does not tender. Everything suggests that the prudent course is to tender, or in the alternative, sell to an arbitrager and thus eliminate all risk that the offer may somehow or other fail.

We have then management which to do its job must necessarily make plans, undertake capital commitments which may be years bearing fruit, do research and development that may be

The **Chairman**. Thank you very, very much, Mr. Sommer.

Mr. Wheat.

STATEMENT OF FRANCIS M. WHEAT, PARTNER, GIBSON, DUNN & CRUTCHER, LOS ANGELES, CA

Mr. **Wheat**. Thank you, Mr. Chairman, for inviting me to appear before the committee today.

[The complete prepared statement follows:]

long in reaching the bottom line, but every day is confronted with the constant prospect that their enterprise may be selected in the lottery as the company a tender offer practitioner goes after. When that happens, the question is not whether the management has done a good job, whether it will prosper over the long run, but whether management can ward off the attacker by breaking up or restructuring the company to provide an immediate return to shareholders worth more than the price of the company's stock in the erratic, unpredictable market.

Imagine the sort of economic world we would have if every company in the nation went into a defensive posture: forewent long term planning, gave up R&D, was managed solely for the sake of driving up the price of its stock as high as it could. And yet that is what is being done. Every day we read of companies acknowledging that they are taking measures to maximize the price of their stock simply to minimize the danger of a hostile tender.

One by one the courts, the SEC, the cunning of the offerors and their advisers, have denied management virtually every means to thwart takeovers. Virtually the only companies in recent times that have avoided being taken over once they have been pinpointed by a raider have been companies that have chosen to undergo radical self-inflicted surgery that has in virtually every instance resulted in sharply increased debt and interest charges, well-laid plans jettisoned, research, development and exploration expenses sharply cut, employees demoralized, and a company ill-equipped to ride out high interest rates or recession.

Little wonder that we are said to have become a "casiono society." The fate of almost every company in this country is at the whim of the takeover artists. If they, for whatever reason, decide to put a company into play, that company can never be the same. When the game triggered by the threat of a takeover is finished, the company will have either been delivered to the untender mercies of the bidder, or have found another buyer whose designs for the company may be no better than those of the original bidder, or have been compelled to restructure with excessive debt and the abandonment of business plans that may have been long in maturing. And who is the winner of this deadly game? The one sure winner is the initial bidder who invariably walks off with a handsome profit, either paid by the "white knight" or out of the resources of the company.

It is by no means clear that all shareholders invest with an eye to a takeover bonanza or even welcome a takeover when it occurs. Innumerable companies -- indeed many hundreds -- have submitted to their shareholders charter amendment proposals which have the effect of reducing the likelihood of a hostile takeover. These measures have included so-called "supermajority" provisions, "best price" provisions, two classes of common stock with different voting rights, and various other provisions. The fact that a takeover opportunity may be lost if the proposal were adopted has in every instance in accordance with SEC rules been fully, prominently disclosed to the shareholders in the most forceful and direct fashion. The fact that generally shareholders have approved these measures, often by very substantial majorities, suggests that there are still -- happily -- in this country investors who do have a long range perspective and are not in the market for a quick killing.

Those who would defend the hostile takeover generally justify their attitude with two time-worn arguments: first, there should be a free market in the control of corporations, just as there is for other "goods" or "commodities"; and two, the threat of the hostile takeover is necessary to keep management on its toes.

Two of the economists who defend the hostile takeover have said that the control of corporations should be as freely tradeable as apples. What an absurd idea: to equate a Goodyear, a Chrysler, a Hewlett-Packard, an IBM, each with its unique history, its long range plans to assure its competitiveness both

here and abroad, its family of employees and their communities, the suppliers and customers who rely on it -- to compare these unique enterprises with apples, to be bought and sold like apples, betrays a gross misunderstanding of what American enterprise is all about.

No one asserts that control of any corporation should be frozen or immobilized; many corporate combinations have clearly benefitted shareholders without destroying values which matures over many years. To recognize this, however, is far from concluding that takeovers heedless of every concern save immediate profit for the offeror produce benefits that exceed the harms they inflict. Long before takeovers were commonplace such combinations were freely accomplished with little or no adverse effects on the corporations involved.

The second rationalization of the tender offer is that it is necessary to keep management on its toes. There is an abundance of forces monitoring management and assuring its performance. A company's commercial bank is constantly alert to falterings in a company, and it has the power to push management into better practices. Similarly fund managers by their acquisition or disposition of a company's stock evidence their approval or disapproval of its management and these signals are quickly translated into action. Financial publications are quick to identify laggards and this has a profound effect on the ability of the company to secure financing and be responsive to shareholders. The rating services exercise a constant discipline on management. For all its shortcomings as a measure of value, the price of the company's stock serves to alert management to the perception of management in the financial world. And increasingly outside directors are policing management and we read frequently of company officers who have been ousted at the behest of outside directors. None of these means of monitoring and disciplining entails the costs and disruptions associated with hostile tender offers.

The problem you are confronting in these hearings is a complex, many-faceted one. It will not be solved with a "quick fix," a band-aid, or a touch of balm. You must look at the profound change that has occurred in the relations between management and a large segment of shareholders of our corporations. We demand of management that they be capable of competing against enterprises not only in this country but throughout the world. This entails long-range planning, developing products that may be half a decade or more before they are in the market. At the same time we give free license to buccaneers who aren't concerned in the slightest with these matters, but who are concerned solely with what these "apples" will bring in the market today. There is no way that management

can do the job we are asking them to do in a jungle like the one that exists today.

I would suggest that it is more than a coincidence that hostile takeovers are totally unknown among our principal competitors, the Japanese and the Germans. Their attention and efforts are not diverted by concern over whether the stock price is high enough to make them unattractive to the predator, and they are not compelled to manage "defensively." Perhaps this is the principal lesson to be learned from them.

Mr. Chairman, members of the Committee. This Congress may be the last opportunity we have to put an end to the ruinous activities that accompany hostile takeovers and free American business to focus its entire attention on the job it must do to make us competitive in world markets. There is perhaps no more crucial domestic issue before this Congress.

Thank you.

TESTIMONY OF
FRANCIS M. WHEAT*
BEFORE THE BANKING COMMITTEE
OF THE UNITED STATES SENATE

JANUARY 28, 1987

HOSTILE TAKEOVERS AND THEIR EFFECTS

Introduction

Thank you for inviting me to appear before the Committee.

Permit me to recall to you the picture of American Corporate life not over three short decades ago. There was plenty of work for lawyers and investment bankers in those days. When we were not helping to raise fresh caital for business expansion--a task which, until recently, I had thought was the primary function of investment banking--we were kept busy with acquisitions, mergers and proxy fights.

How does this scene differ from the one today? There is just one crucial difference. That is, the prevalence today of the hostile tender offer, almost unknown only yesterday. Feverishly involved in this process are a host of specialized entrepreneurs, financiers, lawyers, bankers, and institutional investors who often prepare the way for the attack.

Why has this scene changed so dramatically? It seems to me there is a very simple answer. It lies in the discovery of the tremendous advantage possessed by the hostile bidder and the relative helplessness of the target. For at least two reasons, this advantage has increased in the recent past. One is the development of the junk bond and the enormous sums of cash which can be raised through this means to finance hostile tender offers for the largest companies. The other is the growth in the abritrageur community and the vastly increased capital at its disposal. The professional bidder can develop his plans at leisure and in secret. All he really has to do is to breath the word, and the target is--as the street says--"in play". Now the host of abritrageurs step in and quickly bid up the price of the target's stock. In a matter of days they may own the controlling position. They have only one interest--to see the tender succeed or to promote another bid at a higher figure.

Yesterday, a key question was whether in the judgment of those who knew the company well, the present moment was the best time to sell the company for the benefit of its stockholders. Today that question is of no consequence. Alas, the notion, much discussed in congressional debates and commentary, that the Williams Act, passed by Congress in 1968, established a "level playing field" for the hostile bidder and the target, is a fiction.

Effects of Hostile Tender Offers

Certain economists will argue, on the basis of published stock price data, that shareholders of target companies have generally profited from such tender offers by immediate sale of their stock at prices above the prior market. One cannot, of course, determine whether they would have done better or worse in the longer run had the company remained independent and had they remained its stockholders. Moreover, it is certainly true that in some cases--a small minority, in my judgment--a hostile tender offer will replace an inefficient management with a more efficient one. But the economists cannot easily measure in econometric terms the deleterious effects of hostile tender offers on the business community and the national economy as a whole, and are therefore inclined to disparage their importance. In my judgment, based solely on personal experience, these damaging consequences outweigh one hundred fold the benefits I have just mentioned. They deserve the most careful attention of the Congress. Let me briefly describe what I mean.

If open corporate warfare is to be countenanced in our society, can it not be expected that all manner of defenses will be devised by target companies? Even Congress cannot repeal the law of self defense. I have observed competent, thoughtful, and independent directors of companies leap to their defense when a raid is mounted. Nothing is going to change this, or eliminate the mistakes that are inevitably made, whether decisions are taken by target companies in the heat of battle or in more considered advanced preparation of the trenches. Inevitably, many such decisions will be made with over-reliance on the recommendations of lawyers and investment bankers who are only doing the job they have been hired to do. I have been among them.

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For the moment, I suggest we pass up consideration of such well publicized defensive measures as the poison pill and its derivatives, "greenmail", golden parachutes for management and supermajority provisions. Although these are distasteful and can be productive of unfairness, and seem to draw an inordinate amount of attention from everyone, they do not represent problems of an acute nature. The acute, long-range problems in my judgment arise from five direct consequences of the hostile tender offer:

One, the prevalence of the hostile tender offer powerfully focuses the attention of business management on short term results. Why? With raiders just around the corner, a management does not dare to let any quarterly results lag. In our ever more volatile stock markets, where everyone gets much the same information at the same time, a quick drop in market price is likely to result, and it may provide just the opportunity for a bidder to move. He can offer a premium price and still get an instant bargain. Even if another should outbid him, he makes millions of dollars. So the game is almost always worth the candle, and the inevitable result is to downgrade investment in research (which must be charged against current income) and defer expensive long range product development. As Peter Drucker, perhaps the foremost exponent of corporate management in the country, said in a recent article, the hostile tender offer has become "a dominant force--many would say the dominant force--in the behaviour and actions in American management, and almost certainly a major factor in the erosion of American competitive and technological leadership".

Two, many hostile takeovers depend on the ability of the bidder to repay himself from the target's assets, either by borrowing against them or selling them off piecemeal. One of a few useful defenses a target has is to take on a crushing load of debt, thus denying its assets to its enemy. Often this is done by presenting a debt/equity alternative to one's own shareholders, either by competing a self-tender or by reorganization of the company. If this succeeds, the target will have incurred a debt repayment burden which may deprive it for years of the resources to fund entrepreneurial opportunities in the development of its business which it would otherwise have pursued. And the target will be far more vulnerable to a downturn in the economy. Others, I am sure, have expressed their concern to you over the increasing leverage in the structure of American business.

Three, it was once broadly accepted that corporations should be ultimately accountable to all of their common shareholders. For many years, in line with this objective, the New York Stock Exchange rule required one vote per common share or the company's securities would not be listed on the Exchange. All this has changed under the lash of the hostile tender offer. If common shares with 10 to 100 votes per share could be concentrated in a dominant group, or in the management, the company could proceed with its long-range plans, including raising additional equity capital for expansion, without the fear of hostile attack. It is the one sure defense. So, quite naturally, many companies on the New York Exchange, accepting the risk of delisting of their shares as the lesser of two evils, have installed such disparate voting common stock structures. The AMEX and NASDAQ markets are prepared to welcome them if the New York Stock Exchange should act. I have been a member of the Legal Advisory Board of the New York Stock Exchange for some years and have observed the reluctance with which the Exchange, in order to protect its marketplace from erosion, finally reached the point of proposing to the SEC last September that it be permitted to eliminate its current rule of one share, one vote. As you know, the SEC is considering the issue.

Some people ask: What is so bad about this? The stock prices of common shares of companies which have installed disparate common stock voting structures have not dropped noticeably, they argue, so who has been harmed? Alas, this is but one more example of the unfortunate tendency to measure policy by the simplistic standard of stock prices. I am not arguing for corporate democracy. In fact, I think that term is greatly misused. Corporations do not operate as democratic structures. They could not. But there is an old axium that great power should be accountable to someone other than itself, and in our system, great power is held by corporate management. If corporate management is not ultimately accountable to public shareholders, in the sense that it can in the last resort be replaced by a majority of common shares, a serious vulnerability will, I think, have been introduced into the structure of American business. If no longer accountable to shareholders, So the clear responsibility would appear to lie with the Congress, if anything significant is to be done.

Two years ago, I ran across a speech by Congressman Peter Rodino on the subject of hostile tender offers. In it, he suggested that independent directors of target companies be given authority, by Federal law, to reject a hostile tender offer if in their judgment it was a poor time to sell the company or for other reasons such rejection was in the best interests of the stockholders. The idea appealed to me as a way to put an end to hostile tender offers in a way most consistent with traditional corporate governance under state law. Almost all state corporation laws require that the Board of Directors of a company to be acquired in a merger (as well as its shareholders) must approve the transaction before it may go forward. It would seem that wider interests than the pure self-interest of shareholders in the price immediately obtainable for their shares was thought to deserve protection and the Board of Directors was given this role.

The idea has many problems, but only something of equivalent boldness might stand a chance of ending the damage resulting from the effects of hostile tender offers.

This does not, of course, mean that less definitive measures might not moderate that damage, somewhat. The two-tier tender offer, which is still with us (although to a lesser extent than before) could be deterred by requiring all acquisitions of over 5% of the outstanding shares of a target company to be by tender offer for all of the outstanding stock. This proposal, as well as the suggestion dramatically to slow the tender offer process, have been advanced by Martin Lipton of New York city. If a non-negotiated, hostile tender could be put on ice for several months, at minimum, it would cool off the ardor of the arbitrageurs and make possible more thoughtful decisionmaking by the target's board of directors. Other suggestions may deserve study, some of which, unfortunately, would adversely effect the voting power of ordinary shareholders. I would tamper with that only as a last resort.

Finally, any potential legislation must be studied in light of present day realities affecting the ownership of business corporations. Much has changed in the last several decades. The successful concurrent growth of both hostile tender offers and the business of risk arbitrage are in a sense reflections of a sea-change in the nature of equity ownership. It may be that the only practical solution lies in finding a way to modify

what Business Week colorfully called "the casino society" and Professor Drucker termed "speculator's capitalism."* Is this the sort of capitalism we believe truly serves this country? On the answer to that question, in Drucker's words, "... the future of free enterprise--and perhaps even whether it has much of a future--may well depend."

Thank you for the privilege of appearing before you.

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*On this subject, a somewhat more lengthy comment from Mr. Drucker's article in the Wall Street Journal of September 30, 1986 entitled "A Crisis of Capitalism" might be illustrative. "Corporate managements", he observed, "are being pushed into subordinating everything (even such long-range considerations as a company's market standing, its technology, indeed its basic wealth-producing capacity) to immediate earnings and next week's stock price. A Marxist might well say that corporate capitalism has turned into "speculator's capitalism."

Elaborating further, Mr. Drucker says "... pension funds now own a third of the equity of all publicly traded companies in the U.S. and 50% or more of the equity of the big ones. Stock ownership has thus become more concentrated than probably ever before in U.S. history. Therefore any business that needs money--every business sooner or later--has to be managed to live up to the expectations of the pension-fund managers. And a pension-fund manager has little choice but to focus on the very shortest term; his own job depends on showing immediate gains, with his performance in most cases judged quarter by quarter. This is because the earnings of his boss, the company whose pension fund is being managed, depend in large measure on the short-term performance of the pension fund. If it shows substantial short-term gains, the company's liability for its pension-fund contribution goes down that year and its reported profits go up. Conversely, if the pension fund in a given year underperforms, the company's liability for pension-fund contribution goes up and its earnings go down. Company managements thus put relentless pressure on their pension-fund people to produce immediate gains; the pension-fund people in turn, pressure the managements of the companies in which they invest to produce short-term gains. These, in turn, pressure their pension-fund managers to produce short-term gains, and so on in a vicious circle."

The **Chairman**. Well, thank you, gentlemen, for three really very, very impressive and useful statements. We very much appreciate them.

MANIPULATIVE TAKEOVER

I think a great deal of this was covered in the statements by you three gentlemen, but I would like to ask about another aspect of takeovers, hostile or nonhostile, and that is the manipulative takeover. In other words, the takeover that is not really aimed at taking over but at having a mass for kind of a stock pool.

Now this is what happens I find in about 80 percent of the cases. One of the most prominent takeover experts has never really taken over a corporation. He always builds the price up and sells out and makes a big profit and leaves the corporation with an enormous debt. You might call that a manipulative takeover.

Now there's one solution that might define what I'm talking about. The solution would be to require that when you trigger section 13(d) with 5 percent of the stock of a corporation, that as of that time you are locked in for the ensuing 5 years. You can't sell for 5 years unless you return to the corporation whatever profit you make. In other words, if you move in you've got to mean business. You move in to take over. You don't move in just to manipulate the stock up.

What do you think of that kind of a proposal and if you don't think it's very good, what would you do about these manipulative efforts?

Mr. **Hills**. A manipulative effort only works if there is reason to believe that others are accumulating stock with you. In other words, if you are able to put the company into play because you've taken a large position, it's only because you know by the grapevine or just because of the habits of others that other people are accumulating stock also.

Once it's in play, then you have two choices. One, you can try for greenmail; or, two, you can keep it going until somebody else decides he has enough capacity to take over the company and buy you out.

It seems to me two things are appropriate. One, that, as Frank Wheat has said, the notion advanced by Congressman Rodino, if you could give more authority to the directors to deal with that, both for good and for bad, by holding them to a fiduciary responsibility and giving them a chance to accept or reject any alternative offered them, whether it's selling the company as a whole or whether it's greenmail. And the second thing, of course, is I would require an enormous disclosure requirement when anybody is accumulating stock when he has reason to know that it's being accumulated elsewhere. In other words, if Mr. Boesky has got 4 or 5 percent and is making a play or one of the other gentlemen, and I'm an arbitrageur and I pick up 1 or 2 percent of the stock knowing that there are a lot of people like me, I think the disclosure requirement is much higher.

So I would tend, Mr. Chairman, to move toward disclosure and greater responsibility on directors. The poison pill after all, as ugly as it is and as unseemly as it is, does if used properly give the directors that alternative of saying, "We will or will not accept the offer."

The short swing profit idea is possibly a good one. I guess my approach would be—it may seem strange—but people do sometimes buy an interest in companies because of essential values. People do honestly try to make a friendly takeover. Sometimes they back away or sometimes they say:

> Well, if you won't let me buy the whole company, would you let me buy that division over there that isn't doing very well. I think I can do more with it than you can do with it.

And so sometimes they sell their stock and take a company.

It's a little tough to tell people they can never make money if they buy 5 or 6 percent of the stock of a company. So I would move for disclosure and greater director responsibility.

The CHAIRMAN. Last year I introduced a bill similar to what Mr. Wheat was suggesting, similar to it in the sense that the outside directors could help the Congress define a hostile takeover. In other words, if they opposed it, then it became hostile and then it would require a two-thirds vote of the stockholders instead of a majority vote in order to take over the corporation.

We weren't successful in getting that adopted, but that would be one version of it and it would be kind of a compromise and wouldn't go all the way.

Mr. HILLS. A lot of States—I think three of the boards on which I belong have such a rule because the States in which they are incorporated permit it.

Mr. WHEAT. That is true, Mr. Hills, but the problem is that those laws have been routinely held unconstitutional if adopted by the States. And I commend your bill, Mr. Chairman, because I think on the Federal level it would have a great deal to do with that.

The CHAIRMAN. Why would it have greater constitutionality if the Congress passed it than if the States passed it?

Mr. WHEAT. The problem with the State laws is that you have 50 States and you have shareholders located in New York selling to shareholders located in California, whereas the company is simply incorporated in Minnesota. And if Minnesota requires the shareholders of a Minnesota corporation to vote on whether that takeover can proceed, the courts have held that it is affecting interstate commerce and it is unconstitutional.

The CHAIRMAN. Would that be, in your view, possibly affected by foreign stockholders? You say that there's no problem if you have all 50 States because stockholders are, by and large, Americans. How about the stockholder who lives in the United Kingdom, or Canada, or some other country?

Mr. WHEAT. Well, I don't know, Mr. Chairman, that that would have much to do with it. If you have a Federal law that requires the stockholders of the target company to vote, as you suggested, by a two-thirds vote before the tender offer can proceed, it wouldn't make any difference where the shareholders lived, foreign or domestic. That would be a perfectly constitutional law.

The CHAIRMAN. Mr. Sommer, let me ask you, your testimony seems to place much of the responsibility for takeover activity on the very short-term outlook of institutional investors. You imply that their need for improved performance on a quarterly basis makes them extremely responsive to arbitrageur tender offers.

LENGTHENING THE OUTLOOK OF INSTITUTIONAL INVESTORS

By implication, lengthening the outlook of institutional investors would slow takeover activity.

In your judgment, what could Congress do, what acts could we pass, to lengthen institutional investor outlook?

Mr. SOMMER. Well, Mr. Chairman, some ideas were kicked around this morning. Without necessarily espousing any one or a combination of them, I would repeat them.

One would be to suspend the right to vote for a period of time after the stock was acquired.

The second would be a tax on profits from holdings that were for less than a specified period of time. Many of the institutional investors are tax-free with the result that perhaps a tax on them, if they held stock for less than 6 months or some specified period, might have the effect of elongating their viewpoint and their perspective in a fashion that would make them have long-term concerns for the welfare of the company.

Any of those might be feasible ways of raising their sights, if you would, and have them emphasize more the investment as a long-term commitment rather than simply one to realize immediate profits on.

The CHAIRMAN. Mr. Wheat, witness for the Reagan administration has contended before this committee in the past that hostile takeovers are beneficial to the economy and that concerns about the negative effect of takeovers,

> Are often unfortunately rooted in the desire to preserve the status quo of existing corporate structure in a fashion that can be harmful to the stockholder and to the economy.

Now you take strong issue with that. You made a very clear and emphatic statement about that on page 2 of your testimony where you say, "The damaging consequences outweigh one hundred fold the benefits," again talking about hostile takeovers. You also quote Peter Drucker, who as we all know is a distinguished business professor, as saying,

> Hostile takeovers have almost certainly been a major factor in the erosion of American competitive and technological leadership.

Can you explain why you agree with Mr. Drucker and disagree with the Reagan Administration on this issue?

Mr. WHEAT. Much of what I would say has already been said, Mr. Chairman.

First of all, of course, the inevitable defensive measures which are going to be taken—you can't repeal the law of self-defense—are doing immense damage to American business. You can't prohibit those without prohibiting a hostile takeover or you will have simply stripped American business of any defense whatsoever.

The CHAIRMAN. That was exactly my point when Mr. Rohatyn was testifying and I pointed out that he had defense after defense that he would just strike, and Senator Metzenbaum, whom I greatly admire—he's been a wonderful Senator, I think in many ways the most valuable Senator we have—but he would do the same thing.

What I'm afraid of is what we're going to end up with is a series of knocking out greenmail, knocking out poison pills, knocking out shark repellents, knocking out all the defenses, and you end up with more mergers than ever.

He said, "We would balance that by weakening the offense." He wasn't very specific on that.

Mr. WHEAT. As my testimony has indicated, I think focusing on those defenses is an error. You have to focus on the central problem, which is the enormous advantage of the hostile takeover an entrepreneur has. The problem is, that although in rare instances you have replaced an inefficient management with a more efficient one by a hostile takeover, my observation is that that occurs only in rare instances. In most instances, the takeover entrepreneur has immediate short-term profits in mind and in case after case when he has taken over the company he sells off the assets, breaks up the company, jobs are lost in all directions, and you have immense damage (in my book) to the American economy.

I wish I could agree with the force of the comments by the administration, but my observation from experience is exactly to the contrary.

The CHAIRMAN. Mr. Sommer, would you like to comment?

Mr. SOMMER. Yes, Mr. Chairman. I think a good example of what happens in the face of a takeover was Goodyear. This was not a case in which they were taken over, but in order to defend themselves against a takeover, they undertook a massive restructuring. They had been embarked upon a well thought out diversification plan because of the rather level nature of the tire business. So they had acquired an aerospace business and several other businesses.

When they were attacked by James Goldsmith, the only way that they could escape was by restructuring in this fashion. They incurred a tremendous amount of debt so that they could make immediate payouts to shareholders. They sold off many of their diversifications. They reduced their R&D by 10 percent and they were left basically in the tire business which good planning and good management had indicated they should get out of—not get out of entirely, but reduce as far as the total significance to the company was concerned.

Now that was one result of a threatened takeover and the means that they felt they had to resort to to avoid having that company broken up in whatever fashion James Goldsmith would have broken it up.

This is the sort of thing that happens not infrequently.

UNOCAL SITUATION

The CHAIRMAN. Well, I'm going to call on Mr. Hills in a minute, but I would like to point out that precisely that happened to Unocal. Unocal quidrupled its debt. It went from $1.2 billion to $5.2 billion. And in view of what happened with the takeover, now every day that they open their doors they've got to pay $3 million a day just to pay interest on their colossal debt that they cannot spend on R&D or on manpower training or on new equipment.

They are paralyzed by that. But I'm not sure that I see—even though your statements have been excellent—a practical action that we can take and get passed.

Peter Rodino's speech was a fine speech and my bill was I think a fine bill, but neither of them got anywhere.

Mr. HILLS. Well, I would like to say just a small word in favor of what Schumpeter called "creative destruction," because while the economics——

The CHAIRMAN. Would you say that again?

Mr. HILLS. The famous phrase of Joseph Schumpeter, when he said we should have cycles of change in our society, and I think that the threat of losing control of a company is a real thing and it has a real benefit. I don't think I have to be opposed to hostile takeovers to say that there are many practices that we should attempt to avoid and maybe legislation could help, but I must say that I see many better managers because they are afraid of losing control of the company.

I think whatever we should do, we should not alleviate that pressure. So if I could just leave that and say again that I think that the capacity of independent directors to be tested in this area is a major factor and if you can find an easy way to give the discretion to them with respect to their authority and at the same time make them liable or responsible for exercising that in a fallacious way or in a selfish way, you may have solved the problem.

The CHAIRMAN. In your judgment, gentlemen, why is the real muscle, the real force, on the side of the takeover people, on the side of the offerer?

Mr. HILLS. Because the stock is undervalued.

The CHAIRMAN. Why is the stock undervalued?

Mr. HILLS. Because of what I think are long-term economic deficiencies. We have a higher cost of capital in this country than any other major industrialized country, with the possible exception of England. And until we get around to changing that, we are always going to have problems like this.

If it's undervalued, people are going to prefer to get the stock and buy the capital because it's worth more.

The CHAIRMAN. Only if they can do something about it. Is it undervalued because of managerial incompetence?

Mr. HILLS. Sometimes. But you're still getting the control you see. If the capital is there and you can get it cheaper than going out and buying the pieces of individual equipment, then you're going to take the stock. I think Alan Greenspan made a very thoughtful analysis of the different prices and I think we've got to recognize that we've gone through a different era also. In the last 11 years in the competitive financial markets the cost of capital has come down and is coming down and as the cost of capital comes down, because we shift from banking to differing kinds of financial intermediation, that's a place for change. If somebody can anticipate the cost of capital coming down, then he will try to get control of something that will be worth more to him later than it may be worth to the stockholders at the present time. We've gone through enormous change in just a very short period of time.

The CHAIRMAN. Mr. Sommer.

Mr. Sommer. Well, I think that's only part of the story, Mr. Chairman. I think another part is the fact that people's perceptions—though I think erroneously—have changed with regard to the risk that's involved in leverage. We have had conventional standards in this country with regard to what is a properly leveraged company and I think those have changed radically.

I was at a meeting recently at which a $300 million deal was being discussed and reference was made to the fact that $30 million of equity was going to be in the deal and someone said, "That's a lot of equity." Well, I didn't think I would live long enough to think 10 percent was a lot of equity. So that perception has changed.

Second, the easy availability of junk bond financing has been a strong force on the side of the would-be takeover person.

The third thing is that the target companies have been virtually stripped of any capacity to defend themselves except by going through the same sort of exercise that the offeror would go through if he succeeded in taking over the company.

Those I think are major factors that have balanced the weight in the favor of the offeror or the takeover artist.

The Chairman. Well, how about a private right of action on margin requirements so that you could make them effective so that if somebody wanted to take over a corporation they would have to do exactly what every other stockholder has to do, comply with Federal Reserve margin requirements?

Mr. Sommer. That, among many things that were mentioned here this morning, I think would be very beneficial.

The Chairman. And then be sure that when we pass legislation that strikes greenmail and shark repellents and so forth, if we do it, that we do find at least some equally effective way of diminishing the power of the takeover people if we can find it. If not, we shouldn't strike the defenses.

Mr. Sommer. I agree.

The Chairman. Well, gentlemen, thank you very much. As I say, this has been excellent testimony and very helpful.

The committee will stand in recess.

[Whereupon, at 12:35 p.m., the hearing was recessed, to be reconvened Thursday, January 29, at 10 a.m.]

HOSTILE TAKEOVERS

WEDNESDAY, MARCH 4, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Sarbanes, Dixon, Sasser, Sanford, Shelby, Graham, Garn, Heinz, Armstrong, D'Amato, Hecht, Gramm, Bond, and Chafee.

OPENING STATEMENT OF SENATOR PROXMIRE

The CHAIRMAN. The committee will come to order.

This committee has heard from many illustrious witnesses before, but I think we have never had a more illustrious, intelligent, qualified, celebrated series of witnesses than we have here this morning. You are a fine example of American management at its very best, so I want to express my own pride and gratitude to you gentlemen for coming.

I know you are very busy men, and you have very heavy responsibilities. We are all conscious of that; however, we have an extraordinarily difficult challenge with the hostile corporate takeovers that have come forward in this country in the last couple of years, particularly last year, when we had 9 of the 10 biggest mergers in the history of this country. They seem to be accelerating this year.

Today we begin our second hearing on the general subject of the need for reform of the procedures, practices and financing of hostile takeovers as well as on the effects of these activities on the economy, productivity and competitiveness.

Recent events have heightened the concern of this committee about the soundness of the financing of some of these transactions as well as the web of relationships between bankers, raiders and arbitrageurs involved in these deals. We are also most interested in hearing your views on the effects of hostile takeovers on employees, communities, creditors, customers, suppliers, shareholders, and other corporate constituents.

Peter Drucker, probably this country's foremost expert on American business management has stated that:

> It is increasingly hard to defend the unfriendly takeover as benefiting anyone other than the raider—and a few investment bankers and merger lawyers.

He goes on to state that:

> A good many experienced business leaders * * * now hold takeover fees to be a main cause of the decline in America's competitive strength in the world economy—and a far more potent cause than the high dollar. It contributes to the obsession with the short term and the slighting of tomorrow in research, product development, market development and marketing, and in quality and service—all to squeeze out a few more dollars in next quarter's "bottom line".

I share many of these same views.

Meanwhile, allegations are now becoming commonplace that investment bankers are putting companies into play and manipulating the stock of takeover candidates. Two weeks ago, a major investment banking firm was formally accused of trying to extort another company's management into a takeover and manipulating that company's stock to thwart a stock offering.

Before that it was reported that one of the heads of the merger and acquisition department of another prominent investment banking firm had claimed the ability to put a company in play.

Whether these allegations and reports are in fact true, I have no way of knowing. But I am now clearly concerned that a number of the deals we have seen over the last couple of years may have been fee generated on the part of the investment banking and risk-arbitrage community and not in the best interest of either the economy or the country.

Issues that we will continue to look at include the following: the relationship between bankers, raiders, and risk arbitrageurs with a focus on the cooperation and exchange of inside information, the relationship of junk bond financing commitments, and the breakdown of the Chinese wall.

I have written a letter to SEC Chairman John Shad, dated February 17, 1987, asking the Commission for specific information regarding risk arbitrageurs. At the very least, it is high time that we require all risk arbitrageurs to register separately and specifically with the SEC; and that we consider precluding brokerage firms and their employees from investing in, or owning any securities issued by, third-party risk arbitrage operations.

With the arrest of four top Wall Street financial executives last week, and Ivan Boesky before that, it has become crystal clear that risk arbitrageurs are systematically involved in a highly negative way in corporate takeover abuses. A burning issue must be whether there ought to be a complete separation in the future of risk arbitrage and investment banking. Standards have deteriorated to such an extent in the investment banking community and on Wall Street today that it is absolutely essential that if the Chinese wall is to be preserved at all, it must be completely re-examined, rebuilt and refortified. Otherwise, we must question the rise of the multi-department firm—with traditional underwriting, junk-bond underwriting, leveraged buyouts, new-products creation, venture-capital investing, securities trading, risk arbitrage and merger and acquisitions all operating under the same roof and with the same pool of capital.

Finally, I must say that I am appalled at the lack of supervision at many of our investment banking firms today. Securities firms and their chief executive officers must be held publicly accountable and responsible for the sscandalous activity of some of their highest ranking officials—and the plain fact of the matter is that is not the case. Instead, there seems to be an overwhelming ho-hum, business as usual, attitude on the part of many Wall Street firms that know there are serious problems. That must change.

In the past we have heard quite a bit about the benefits of hostile takeovers. But until now, we have never had such a distinguished list of corporate chief executives to articulate their views on the subject. I look forward to the testimony of our three panels this morning and believe that never before in the history of this committee have we had so many highly distinguished corporate chief executive officers in this room at the same time.

The CHAIRMAN. Senator Heinz, do you have a statement you would like to make?

Senator HEINZ. Mr. Chairman, I just want to commend you on these hearings. I agree with your comments that we have several panels of extremely distinguished witnesses to testify today. I am delighted to see one of my constituents, Dave Roderick, of USX Corp. I do not want to take the committee's time further in any other way. I look forward to hearing what they have to say.

The CHAIRMAN. Since you mentioned Mr. Roderick, I have got to boast about John Murray of the Universal Food Corp. We are very proud of Mr. Murray and his fine corporation. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman. On subsequent panels, there are representatives from my State of Michigan, which I will appropriately brag about at that time, but let me just say, I want to commend you for holding these hearings. I think these are very important hearings, and I would agree with you that if you take our three panels that we have here this morning, I am not aware of any more distinguished group of business leaders in this country appearing before the Congress on a matter of great importance than those we see today.

I hope that in the course of your comments you would address both sides of the argument that we hear all the time. One side of the argument, those that would favor hostile takeovers say that in the aggregate that they are beneficial for the economy, that they perform many valuable functions, in terms of allocating resources, promoting economies of scale, increasing the return for investing in the stock of publicly traded companies, et cetera, et cetera.

On the other side, and I assume many of the points that you will be raising today is the fact that this can work exactly the other way. Corporate treasuries can be looted, plants can be shut down overnight, communities impacted. Our ability to invest in long-term research type, technological type activity can be badly damaged at a time when we need to increase productivity and strengthen our economic performance.

So I would hope that you would each try to address what arguments you may think are valid on both sides of that very sharply drawn debate, so that we have some way to try to understand where the balance, in fact, might lie.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Riegle. Senator Garn.

Senator GARN. In the interest of time, I will put my statement in the record, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I will put my statement in the record, in the interest of time, but I do want to point out that there are three distinguished corporate leaders from my State here that will be on the panel: Don Clark, chairman of the board and chief executive officer of Household International; Clarence E. Johnson, the chairman and chief executive officer of the Borg-Warner Corp.; and William Smithburg, chairman and chief executive officer of the Quaker Oats Co.

The CHAIRMAN. Thank you very much. Senator Armstrong.

Senator ARMSTRONG. Mr. Chairman, my opening statement has been overtaken by events. [Laughter.]

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement that I would like to submit for the record, but I do want to commend you for bringing such a distinguished group before the committee.

And we all want you to try to answer the question that Senator Riegle posed a minute ago. We hear both sides of it. Are takeovers good for the economy or are they bad? What is it going to do to disrupt jobs, and so forth? I am looking forward to your testimony today.

OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

Senator RIEGLE. Mr. Chairman, even before the first witness testifies this morning, I think a very important point has already been made; namely, that the corporate community has now for the first time come out in full force before the Congress to make their views known on the subject of hostile takeovers. This is quite a change from the past, when individual companies and their chairmen would privately communicate their concerns but were afraid to testify for fear of being highlighted as a potential takeover target.

Clearly these issues have two sides. Proponents of hostile takeovers argue that they are, in the aggregate, beneficial for stockholders and for the economy as a whole and that these takeovers can perform several valuable functions. In particular, according to this argument, these takeovers can allocate resources to higher valued uses, promote economies of scale and scope, increase the return from investing in the stock of publicly traded companies, reinforce market incentives that require management to compete effectively, free up capital for new investment opportunities, and move assets to smaller, more focused companies.

Opponents, on the other hand, believe that while such hostile takeovers may serve useful purposes, many loot corporate treasuries; undermine our ability to compete in world markets; force management to sacrifice long-term strategy and the development of new products and services for short-term gains; inhibit innovation; lead to the misuse of capital; cheat shareholders; and cause losses and economic upheaval that disrupt the lives of communities and workers.

There is also increasing concern that pools of investors may be putting companies into play for their own enrichment without any real intention of running those companies, that the financing of some recent takeover attempts may have been based on less than solid financing and that some takeover entrepreneurs may have been manipulating the market.

I look forward to a thorough discussion of these issues today. This is clearly the most prestigious group of corporate chief executives that we have ever assembled in the Banking Committee since I have been a member of this committee. Their presence, because of the calibre of many of the companies they represent, also challenges in no uncertain terms the argument that it is only weak, poorly managed companies that are concerned about hostile takeovers.

Mr. Chairman, I congratulate you for inviting these witnesses and know there were at least two or three times as many CEO's who would have been delighted to have been here with us today. I look forward to the testimony we will be hearing shortly this morning.

OPENING STATEMENT OF SENATOR JAKE GARN

Senator **Garn**. Thank you, Mr. Chairman. This morning the committee will be examining further the issue of corporate takeovers and their impacts. Most of the debate surrounding this issue has been focused, not surprisingly, on hostile takeovers—as conflict is more dramatic news than consensus. While it is generally argued that friendly takeovers provide benefits and are good, hostile mergers and acquisitions have been blamed for many problems—including the recent outbreak of insider trading. I, like many others, am outraged by these illegal activities. However, I point out that the majority of the deals cited in recent SEC complaints in which insider trading occurred, were considered as friendly acquisitions or restructurings.

While we have had a good deal of input on corporate takeover issues, dating back to the 4 days of hearings conducted by Senator D'Amato in 1985, we are still faced with several broad questions: Are corporate takeovers good or bad for the economy? Should Congress intervene in the acquisition process? And if Congress does intervene how can it legislate so as to not have a chilling effect on all acquisitions—both good and bad?

The committee must examine these issues in a fair and balanced manner by receiving testimony from individuals from all sides of the debate. A failure to consider the arguments from all of the participants in this debate can only result in the passage of legislation that contravenes the original intent of the authors of the Williams Act by upsetting the delicate balance between bidders and targets.

I look forward to the testimony of this morning's witnesses representing corporate America and hope that they will provide evidence and suggestions that will be a welcome contribution to this debate.

perhaps corporations will come to be accountable to government. None of us, I assume, would like to see a development which risks that possibility.

Four, those of us who have labored in this vineyard have noted, with dismay, the amount of management time and energy which goes into study and discussion about what defenses to adopt, and what possible restructurings to propose. In our business system, we supposedly rely on corporate management to devote its energies to the development of newer or better products and services. What I have seen is the diversion of management talent from these fundamental objectives to an extent not readily measurable, but all to real. Add to that the out-of-pocket expenses of investment bankers, lawyers, shareholder relations experts, and the like, whose fees expand from large to monumental if the company is put "in play". It is all a great game, but the long-term result is likely to be an erosion of our competetive edge in the world market.

Fifth, There is one more important defense to hostile tender offers available to many managements and that is "going private." One can hear the conversation in the boardroom: "No longer will we be at the mercy of those pension funds which today hold 60% of our common stock, gentlemen. The managers of those funds are only interested in short term performance, and would go for any sort of tender offer that gives them some premium over our market price. So we are constantly on edge, but we have been advised by our investment bankers that our excellent cash flow makes us a prime candidate for an LBO. So I am here to recommend it, and may I present to you our bankers and our lawyers who have developed the program which is before you. Of course, we will need another set of investment bankers and lawyers for the special committee..." etc.

To help persuade companies vulnerable to takeover to do a leveraged buyout, a common phrase for going private, a whole industry has grown up in the recent past. Not only are there specialized LBO firms, several of which in the very recent past have raised hundreds of millions of dollars to facilitate their projects, but all of the major investment bankers have allocated great talent and vast amounts of money to the LBO business. The profits are enormous. The happy management team of the potential target, freed from vulnerability to a hostile tender offer, offered the chance to triple or quadruple its personal stake in the company, and saddled with a new and ferocious debt to pay, rides off into the sunset. But what has happened to the American financial markets and opportunities for the small investor in the process? Some

months ago the Federal Reserve Board estimated that in the year 1986 alone, aggregate corporate debt would increase by approximatley $200 billion while aggregate corporate equity would shrink by over $100 billion. This is a trend which has been in effect for several years.

Permit me to emphasize the point once more. All of these dangerous effects on our competitive business system--the focus on the short-term, the greatly increased leveraging of business enterprise, the erosion of corporate accountability, the diversion of management time and energy from productive effort, and the gradual reduction in the strength of our public equity securities markets, so critical to the capital formation process that has developed in this country--all stem directly from the hostile tender offer.

I might add, although this is a personal impression, that the recent wave of hostile tender offers seems to have stimulated a kind of greed in our society that I cannot recall observing in the past. Vast profits are made in this takeover game. Persons employed on the periphery, observing what others have made, cannot help but wish to be on the gravy train. Prospective tender offers furnish the most tempting of all opportunities for trading on non-public information, since the payoff is so immediate. The temptation to join an insider trading ring is almost overwhelming. All of you have read stories of those who have succumbed to it.

What Should Be Done?

Let me express one definite hope. That is, that your Committee will not focus its attention on the relatively less significant consequences of hostile tender offers. Little would be accomplished if you do. Greenmail, poison pills and the like are mere symptoms of the disease. If you suppress these symptoms, the disease itself will be all the more rampant because you will merely have deprived target companies of one or two of the devices they have attempted to use to fend off the hostile raider.

Instead, I hope you may focus on the real dangers involved, which I have outlined. This should lead to a study of the key issue: what might be done to remove some of the manifold stimuli to hostile tender offers. One could wish that the states might play a useful role in this, as they do in securities regulation under our Federal system. In fact, many states attempted to roll back, through legislation, some of the crushing advantages possessed by hostile bidders. Almost all of these efforts have foundered in the courts on constitutional grounds.

OPENING STATEMENT OF SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, I want to commend the chairman for his continued leadership in addressing the ramifications of corporate takeovers as we begin our second hearing on this issue.

The central question facing this committee is: With the increasing number of hostile takeovers, are we, to use Wall Street's phrase, "putting into play" America's future, its economy and its competitive position. Are we putting into play a corporation's stockholders, its employees and the communities in which they operate?

It concerns me that a small number of corporate raiders can play with jobs and livelihood of thousands of my constituents in Alabama for the sake of the raiders' own greed and profit.

The recent rash of hostile takeovers raises serious public policy concerns: Are hostile takeovers subordinating our corporations; and America's long-term goals for short-term profits?

In financing and defending hostile corporate takeovers, are we leveraging America's future? It has been estimated that corporate debt increased by $200 billion in 1986 and that corporate equity declined by $100 billion. Is this debt forcing us to preempt allocation of resources for research and development, increased productivity, expanded facilities and increased jobs? How will America's debt-laden corporations fare in an economic downturn?

These concerns are particularly relevant as America strives to maintain its competitive edge in the global marketplace.

An area that also needs to be addressed is the securities laws and regulations governing corporate takeovers. Are these rules one-sided in favor of the corporate raider? Particular attention should be given to the section 13(d) rule and the minimum tender offering period.

But in reviewing these rules, we must be cautious not to stifle American business. Mergers and acquisitions, in many situations, may be a sound and prudent business practice if they breed a stronger, more productive and competitive enterprise capable of meeting long-term goals.

Mr. Chairman, the growing market of businesses buying and selling other businesses is a serious matter to our Nation.

We are most fortunate in having these panels of distinguished witnesses before the committee today to share with us their experiences and concerns. I look forward to your comments.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning to hear the views of 15 very distinguished chief executive officers of some of America's greatest corporations. At the outset, I would like to note the presence of three witnesses from my own State of Illinois.

First, is Don Clark, chairman of the board and chief executive officer of Household International, a major multi-industry corporation headquartered in Illinois. Household is a good corporate citizen, and Don has taken a personal leadership role in a number of activities to better the city of Chicago and our State.

Second, is Clarence E. Johnson, the chairman and chief executive officer of the Borg-Warner Corp., headquartered in Chicago. I know the committee will find his comments incisive and extremely useful.

Third, is William D. Smithburg, chairman and chief ececutive officer of the Quaker Oates Co., also headquartered in Chicago. He is not only the chairman of an Illinois-based company, he was also educated in Illinois universities—DePaul and Northwestern—which makes him a person to listen to in my book.

I know the committee will benefit greatly from the testimony of these three fine Illinoisans. I look forward to hearing from them and from the other corporate leaders who have taken time out of their busy schedules to be with us here this morning.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, I want to welcome to the Banking Committee this morning our distinguished panel of witnesses from the corporate business community who will share with us their views on corporate takeover activity. I am very interested in listening to their testimony since I have been advocating for reform of the Federal securities laws governing corporate takeovers for several years.

The public debate on corporate takeovers has been waged in earnest in Congress, the courts, corporate boardrooms, and the Securities and Exchange Commission in recent years. Within the last 4 years, contests for corporate control have become a more frequent phenomena on the American business scene. Once the private domain of a handful of investment bankers, lawyers, and corporate executives, takeover contests have become an increasingly popular spectator sport. The publicity surrounding several recent multibillion dollar acquisitions has familiarized the public with a glossary of new terms including, among others—golden parachutes, greenmail, bear hugs, shark repellant, poison pills, PAC man defense and white knights. These terms have been used to describe the various offensive and defensive tactics which may be employed to effectuate or prevent a change in corporate control.

The probems attendant to takeovers are in the forefront of corporate law and have spawned much congressional inquiry including hearings I chaired on the long-term effects of takeover activity on the credit and capital markets. This committee has also conducted an examination of the adequacy of the existing Federal regulation of the takeover process, the Williams Act, in maintaining a balance between acquiring and target companies.

Any legislative response needs to ensure that shareholders will be able to make well informed decisions on the deposition of their holdings in a corporation subject to a takeover. The protections to shareholders intended by the act have been eroded by recent developments and legal interpretations of the rules governing the takeover process.

I have introduced legislation, S. 227, the Tender Offer Reform Act of 1987, that goes a long way toward restoring the balance between bidders and targets while increasing investor protection. I hope that the witnesses will address some of the provisions of S. 227 because they appear to endorse many of the components of this package in their testimony.

I ask that a copy of the bill, an article addressing the benefits of financial restructuring for the economy, a study on the impact defeated takeover attempts on target shareholders, and a study on junk bonds and tender offer financing be included in the record. At this point I would like to include data gathered by the staff which demonstrates that many of the companies appearing today have taken steps to make themselves immune from takeovers while engaging in a substantial amount of merger and acquisition activity:

ATTACHMENT I

A. *USX Corp.:* Subject to attempted takeover by Carl Icahn in 1986. Icahn withdrew takeover proposal after USX announced restructuring moves, including issuing debt with antitakeover features. No poison pill.

B. *Apache Corp.:* No Schedule 13D's filed in last 5 years. Has adopted poison pill. CEO is member of Stakeholders in America.

C. *Universal Foods Corp.:* No takeover in last 5 years. Harris Associates filed a Schedule 13-D on November 28, 1984, most recent amendment was dated February 27, 1987. Has adopted poison pill. CEO is member of Stakeholders in America.

D. *Transco Energy Co.:* Sold 13.4 percent stake to ESOP in February 1987. No other Schedule 13-D's in last 4 years. Several filings in 1982 and 1983 (Bartar BV; Eastfield). Price runup on rumors in early 1986 of accumulation by Wagner & Brown. Price runup on rumors in 1984 that Coastal or Houston Natural Gas would bid for Transco. Transco made white knight offer for Houston Natural Gas in 1984 when Coastal made a hostile bid; was rebuffed. Has adopted poison pill.

E. *Champion International:* No Schedule 13-D's filed in last 5 years. Major recent divestitures include: sold packaging unit to Stone Container Corp. for $457 million in 1986; sold building products operations in 1985 LBO for $165 million; sold carton plants and two paper mills in 1985 LBO for $100 million; sold coated products operations in 1985 for $100 million. These divestitures followed $1.8 billion white knight acquisition of St. Regis in 1984. Has adopted poison pill. CEO is head of Business Roundtable and an outspoken takeover opponent.

F. *Arvin Industries:* A group (Otho Warren Holland et al.) has been filing Schedule 13-D's and amendments since August 24, 1984, the most recent filing was March 28, 1986. Has adopted poison pill.

G. *Household International:* Household was an early poison pill adopter; at the time it adopted its pill it was subject to a rumored takeover by Dyson Kissner Moran, which was a substantial shareholder. John Moran, then a director of Household, sued to enjoin the pill and lost. Household countersued claiming false Schedule 13-D filed by Dyson Kissner Moran. Household repurchased Dyson Kissner Moran's stake in 1986 for $190 million after Moran threatened hostile takeover in late 1985. Self tender in early 1986. CEO is a member of Stakeholders in America. Sold National Car Rental division in 1986 LBO for $450 million; TG&Y stores in 1986 for $300 million; Von's grocery chain in 1985 LBO for $700 million.

H. *Hospital Corporation of America:* No Schedule 13-D's filed in last five years except filings by Cigna and its predecessor, INA, prior to 1983. Hospital Corp. made a friendly bid for American Hospital Supply in 1985; this was broken up by an intervening overbid by Baxter Travenol. Has adopted poison pill.

I. *J.C. Penny:* No Schedule 13-D's filed in the last 5 years. Has adopted poison pill.

J. *Gerber Products:* No Schedule 13-D's filed in the last five years. Repurchased 4.8 percent stake from Quaker Oats in 1986. Defeated $40 (50 percent premium over market) tender offer from Anderson Clayton in 1978 through antitrust litigation; no claim that price was unfair. Has adopted poison pill.

K. *Schering Plough:* No Schedule 13-D's filed in the last five years. Repurchased 6 percent of stock in open market in 1986. Has adopted poison pill. Sued EF Hutton in 1985 over block accumulation.

L. *Goodyear Tire & Rubber:* Subject to a 1986 takeover attempt by Sir James Goldsmith; paid greenmail to Goldsmith and simultaneously announced self-tender and defensive restructuring. As part of restructuring, sold defense electronics business to Loral in 1987 for $640 million; is negotiating sale of Celeron oil and pipeline unit; sold Goodyear Farms in 1987 for $220 million; sold Motor Wheel unit in LBO. Has adopted poison pill.

M. *Knight Ridder:* No Schedule 13-D's filed in last five years. Repurchased 14.5 percent block from Knight family in 1985. Has adopted poison pill.

N. *Quaker Oats*: No Schedule 13-D's filed in last five years. Quaker Oats was involved in a successful hostile acquisition of Anderson Clayton in 1986; announced plans to sell most of Anderson Clayton's businesses other than pet foods. Sold 4.8 percent stake in Gerber Products back to Gerber in 1986. Made white knight acquisition of Stokely-Van Camp in 1983. Sold three non-food divisions (Jos A. Banks Clothiers, Brookstone, Eyelab) for aggregate $220 million in late 1986. Has adopted poison pill.

O. *Kansas Power & Light*: No Schedule 13-D's in last five years. No poison pill.

Poison pill adoption history: All of the above companies with the exception of USX Corp. and Kansas Power & Light have adopted poison pills. If we exclude Kansas Power as being in a special regulated industry, the pill adoption rate (13 out of 14) is very high and suggests self-selection on the part of those who wished, or were prominent enough, to testify. The hearing participants appear to be especially concerned about takeovers and distrustful of shareholder ability to make corporate control decisions.

ATTACHMENT II

A brief summary of the witnesses' merger and/or acquisition activities includes:

A. USX

1. Acquired Marathon Oil in 1982 ($6.15 billion).
2. On February 12, 1985, U.S. Steel planned to sell, in a leveraged buyout, its Agri-Chemicals division to senior management but the deal was reported to be aborted for "undisclosed" reasons on June 19, 1986.
3. Acquired Texas Oil and Gas Co. in 1986 (exchange of stock).
4. Acquired Continental Fiberglass Division of CFC Corp. in 9/86.
5. Possible LBO of CP Industries—"a new concern organized to acquire the plant"—bought USX's steel plant in McKees, Pa. on 8/1/86.
6. Subject to a hostile bid initiated by Carl Icahn for $7 billion in 1986.

B. Apache Corp—no information found.

C. Universal Foods:

1. Acquired Mid-Continental Industries (soft-drink bottler) for stock, June 1978.
2. Acquired Major Brands (soft-drink bottler) for stock, July 1980.
3. In 1982 bought 4 bottling companies.
4. In October 1984, sold its last soft drink bottling plant in St. Louis, Missouri.
5. In April 1984, exchanged "substantially all" beverage division assets with Philip Morris's Seven-Up division for Warner-Jenkinson Co., a maker of food colors, and cash.
6. On June 26, 1984, repurchased $1 million in shares of its own common stock.
7. July 1985, bought Idaho Frozen Foods Corp. for $39.9 million cash.
8. July 6, 1986, purchased Universal Group (a manufacturer of food flavors) for $30.8 million.

D. Transco Energy Co.:

1. Acquired Petro Source Corp. for $21.7 million on November 4, 1985.
2. November 1985, acquires Exchange Oil and Gas from Georgia Pacific for $145 million.
3. Acquired Paramount Coal from W.R. Grace in June 1985 (price undisclosed).
4. July 1985, acquired Kaneb Services Kentucky and Tennessee coal operations for $235 million.
5. January 30, 1987, sold 4 million shares to an Employee stock option plea—this purchase was financed through a bank loan and will increase employee ownership in the company to 20.3% from 7.8%.

E. Champion International:

1. Acquired Hoerner Waldorf Corp., maker of paper packing products, February 24, 1977, for stock.
2. Acquired St. Regis Corp. for cash and stock effective November 1984, in a series of transactions throughout 1984.
3. September 1985, sold several building products operations to current management in a leveraged buy-out for $165–$175 million.
4. In Aug. 1967, acquired majority control of Intermills S.A., Belgian paper maker, by subscribing to 112,000 shs. at total cost of $3,248,000. A subsidiary previously had bought about a 35% interest for $3,261,000 making company holdings approximately 57.6% of outstanding Intermills stock. Divested in 1977.

5. In early 1968, Company acquired Arrow Transportation Corp. and an affiliated sand and gravel Co. in exchange for 162,500 shs. of $1.20 cum. conv. pref. stock. Arrow is a common carrier by barge on Miss., Ohio and Tenn. rivers. (Sold in 1978).

6. In July, 1968, acquired Drexel Enterprises Inc. in exchange for 1,137,800 shares of $1.20 conv. pref. stk. and 1,280,025 shares of common. (Sold in 1977).

7. On Dec. 18, 1969, acquired Trend Industries, Inc., Rome, Ga. for 3,122,280 common shares by exchange of 0.9 company common share for each Trend share. (Sold in 1978).

8. Also in Dec. 1969, acquired Birmingham Ornamental Iron Co. (Sold on Jan. 31, 1977).

9. On Dec. 3, 1970, acquired Roberts Consolidated Industries, Inc., for 498,671 common shares. By exchange of 0.7 company common share for each Roberts share. (Sold on Nov. 4, 1976).

10. On Dec. 31, 1970, acquired Path Fork Harlan Coal Co. and Tenn-Ky Coal Co., Inc., affiliated coal mining companies, for 182,476 common shares and cash.

11. In 1974, acquired 100% interest in A.W. (Securities) Ltd., a British producer of printed carpet, for $91,000,000 (sold on Nov. 30, 1980).

F. Arvin Industries:

1. Acquired International Metal Products division of McGraw-Hill for $41.6 million cash and notes, April 1, 1982.

2. Acquired Schrader Automotive, Inc., a subsidiary of Scoville, Inc., for about $39 million, in April 1986.

3. January 1987 acquired Maremont (auto parts manufacturer) for $245 million.

4. February 1987, announced that it would acquire Systems Research Labs in a stock for stock transaction.

5. January 1987, announced sale of SACO Defense (munitions) to Chamberlain Manufacturing for $24 million in cash.

G. Household International:

1. April 1976—acquired Keystone Savings and Loan for cash.

2. December 1976—acquired 4 industrial banks in Colorado.

3. March 1977—acquired Alexander Hamilton Life Insurance Co.

4. June 1981—acquired Wallace Murray Corp. for cash and stock.

5. Announced in October 1985, the sale of Household Merchandising for $700 million in a management headed leveraged buy-out.

6. July 17, 1986 stock repurchase—"directors authorized the expenditure of up to $50 million to repurchase its common and $6.25 cumulative convertible preferred shares from time to time."

7. August 1986—acquired J.P. Heilueil Industries.

8. A second $50 million repurchase of Household stock was authorized in September 1986.

H. Hospital Corp. of America

1. In the summer of 1985, HCA and Baxter Travenol began separate takeover contests for American Hospital Supply. Baxter Travenol eventually won out even though American Hospital Supply's management favored the HCA offer at $15/share lower than the Baxter offer. In the settlement of these offers and counter offers, Baxter acquired American Hospital for $3.8 billion and paid HCA $150 million to terminate its offer for AHS and HCA could get another $90 million in 1990.

2. In 1975 acquired Calwell Memorial Hospital for undisclosed terms.

3. In Jan. 1977 formed Parthenon Insurance Co. to insure general and professional liability risk of Co.

4. In 1978, acquired 6 hospitals in the U.S. and 3 hospitals in Australia.

5. In 1979 acquired 7 hospitals in the U.S., 6 in Australia and 3 in Brazil.

6. In the first five months of 1980, acquired 6 hospitals in the U.S.

7. In Apr., 1980 acquired General Health Services, Inc. and its acute hospitals and ancillary health care services for more than $90,000,000 cash or $50 a sh. for 2,600,000 shs. of com. stk. together with additional shs. which may be issued upon conversion of General Health's deps. and stock options.

8. In Feb., 1981 acquired a 190-bed hospital in Dublin, GA., and a 177-bed hospital in Corsicana, Tex. for undisclosed prices.

9. In Apr., 1981 acquired Memorial Hospital La Habra Community Hospital for $36,000,000.

10. On Aug. 26, 1981, acquired Hospital Affiliates International, Inc. from INA Corp., in a purchase transaction, for $425,000,000 in cash. 5,390,000 shares of Co. common stock valued at $190,000,000 and acquisition costs of $6,000,000.

11. In Mar. 1982 Health Care Corp. was merged into Co. Company completed the merger by issuing 455,000 shares of its com. stk. and assuming Health Care Corp.'s liabilties. Value of transaction was about $30,000,000.

12. On Jan. 1, 1983, Co. sold to Republic Health Corp. 18 hospitals and related medical office buildings for $121,000,000 in cash. 200,000 shares (800,000 after giving effect to stk. split) of common stock of Republic and promissory notes. Additionally, Republic assumed certain debt liabilities related to the property sold. Co. also later sold two facilities with assets of approximately $28,000,000. In separate transactions, for cash and the assumption of debt and other liabilities.

13. During 1983, Co. acquired in purchase transactions four hospitals in the U.S. and one hospital in Australia at an aggregate total cost of $20,000,000, including $3,400,000 of liabilities assumed.

14. In Aug. 1984, acquired Hill, Richards & Cos., Inc.

15. In Feb. 1985, acquired an 80% interest in Lovelace Medical Center, Albuquerque, N.M. for approx. $28,000,000.

16. In Mar. 1985, acquired the acute care division of Forum Group, Inc. which consist of 14 hospitals.

17. In Apr. 1985, acquired New Century Life Insurance Co.

18. In 1985 Co. acquired the acute care division of Forum Group, Inc. for approximately $195,000,000: Wesley Medical Center in Wichita, Kansas for approximately $255,000,000 and Presbyterian Hospital in Oklahoma City, Oklahoma for approximately $126,000,000.

19. In Nov. 1985 Co. acquired a 19.5% interest in CyCare Systems, Inc. for $6,975,000.

20. During 1985 Company also acquired several businesses involved in health care finance. The more significant acquisitions were the following (approximate purchase price shown in parentheses); (i) New Century Life Insurance Company ($8 million); (ii) Healthgroup International, a Los Angeles, California based HMO ($22 million); (iii) Health Care Plus, a Wichita, Kansas based HMO ($41 million); (iv) United Medical Plan, Inc., a Richmond, Virginia based HMO ($23 million); and (v) Co-Ordinated Benefit Plans, Inc., an insurance claims processing business with offices in Tampa, Florida and Scottsdale, Arizona ($7.7 million).

I. J.C. Penney:

1. In January 1986, acquired 20% of Alcott and Andrews for a reported $8 million for "investment purposes."

2. October 1985 acquires 25% of Cable Share (home shopping technology) for a premium of 15% above the market price.

3. June 1983, acquires First National Bank of Harrington, Delaware for $7.4 million—a non-bank bank.

4. March 1983, acquires Videotex Systems (a video communications operator) with the aim to provide home banking to farmers in Minnesota and North Dakota.

J. Gerber Products:

1. August 1979—acquired C.W. Transport, Inc., for stock.

2. July 1986—acquired Baby Products Division of Colgate-Palmolive.

3. October 1986—repurchased 985,000 common shares held by Quaker Oats Co. for $49-$50 million. (Had bought it for $47 million.)

K. Schering-Plough:

1. April 1979—acquired Scholl, Inc. for stock and cash.

2. In 1983, acquires Drax (a biotech firm) for $106 million and Muskol (maker of Coppertone) and sells DAP (household sealants).

3. In 1984, Schering-Plough began selling its 12 radio stations.

4. June 1986—acquired Key Pharmaceuticals, Inc. in a stock deal valued at $836 million. Estimated that it would have to cut 200 employees of Key.

5. September 1986—announced a program to repurchase $300 million of common stock.

L. Goodyear Tire and Rubber:

1. June 1983—acquired Celeron Corp., for stock, as oil and gas production corp.

2. January 1986 acquired Formax Oil for $85 million.

3. Targeted by Sir Joseph Goldsmith, successfully defended but had to sell Celeron and paid greenmail to Goldsmith.

M. Knight-Ridder:

1. December 1986—acquired State-Record Co.—newspaper publishers for $31 million.
2. Sold *Detroit Free Press* to Gannett in April 20, 1986.
3. Buys 3 TV stations from Gannett for $160 million, including WALA-Mobile, Alabama, in November 1985.
4. May 1985, Company purchases 14.5% of its common stock from estate of J.S. Knight.
5. February 1985, acquires Trade Center, an electronic graphics product producer.
6. In November 1984, sold cellular mobile radio services to McGraw Cellular Communications.

N. Quaker Oats:

1. September 29, 1986—acquired Anderson, Clayton & Co. for $805 million.
2. September 22, 1986, acquires Golden Grain Macaroni for $250 million.
3. December 11, 1986, sold Jos A. Bank Clothier to group of investors for $110 million.
4. December 15, 1986, sold Eyelab chain to Cole Eyeworks and Brookstone to management and investors.
5. December 20, 1984, sold industrial productions business to an investor group for $50 million in a management led leveraged buyout.
6. December 2, 1986, purchases Kretschmer Cereals—no sum revealed.

O. Kansas Power and Light:

1. October 1983—Acquired Gas Service Co. in a tender offer for $70.6 million and merged with this unit in July 1985.

I look forward to this morning's testimony and hope that the opinions shared will provide us guidance in crafting an appropriate legislative response.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No statement.

The CHAIRMAN. Well, Mr. Roderick, chairman of USX Corp., you are up to bat first. We are delighted to have you. Go right ahead, sir.

STATEMENT OF DAVID M. RODERICK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, USX CORP., PITTSBURGH, PA

Mr. RODERICK. Thank you, Mr. Chairman. I have filed a full statement. I will give a very brief statement.

My name is David M. Roderick. I am chairman and chief executive officer of USX Corp. I welcome this opportunity before this committee and the hearing on hostile takeovers.

The continuing scandal that began with the Boesky incident, I think, simply confirms the need for reform to curb the abuses that have become part of the so-called takeover game. We need to find a way to eliminate the extravagant profiteering by financial speculators. So long as there are tremendous riches available to takeover specialists, arbs, investment bankers, and lawyers, the system will inevitably breed serious abuses and obvious corruption.

Unrestrained greed always produces such evils and abuses.

REFORM THE SYSTEM

We should reform the system to discourage gamesmanship by requiring that those undertaking a reputed takeover must be bona fide. To accomplish this, we need a legal framework that allows the reward to be commensurate with the risk and the beneficial economic result. The real test being whether the acquirer can take over a company and run it better than it was run before.

The rules should defuse the so-called bait and switch strategy of so many takeover artists, where the bait is the fanciful and unlikely prospect of an attractive tender offer being made to the shareholders. This is designed simply to put the target in play. The switch is for the raider to sell out to the target, to other raiders, to other arbs or to a white knight, after the game has been hyped and the stock has been hyped to an artificially induced level.

Eliminate this game playing with its attendant conflict and confrontations by ensuring that hostile takeovers are, in fact, genuine, and you can do that, I think, by first requiring that a raider have his financing in place and certain before any proposal of a prospective tender offer can be made. In other words, eliminate the financing out option of the raider.

Two, requiring that corporate raiders give notice within 24 hours after they acquire 1 or more percent of the target company's stock.

Three, requiring the corporate raider-spectulator to make an all-cash tender offer for all of the remaining stock, once the raider has acquired 10 percent or more of a target company.

Four, requiring the raider in making a tender, to make it for all cash to all stockholders on equal terms.

And five, prohibiting the payment of greenmail by the target and the acceptance of payments by the raider.

I think prohibiting greenmail would keep everyone on the straight and narrow by eliminating the temptation for a raider to take a stock position and stir things up in an effort to be bought off by the target at a fancy premium.

All of these changes that I have outlined are needed to correct the unwarranted advantage the corporate raider now enjoys in making a hostile move on a target company.

I would hope that these reforms would be very promptly made, as they are clearly needed to deal with these obvious abuses in the system. It would help corporate America to manage its business in a more efficient and effective manner without trying to take near-term shortcuts to avoid being put in play by those profiteers who are interested only in the spoils of the battle and not in the better management of the enterprise.

If, however, the all-cash tender offer is fair to all of the shareholders and makes good economic sense, the management should do nothing to impede such a takeover, and Congress should not enact legislation that would restrict bona fide acquisitions.

In other words, gentlemen, what I commend to you is that we get rid of the abuses in the system by raiders but without jeopardizing the legitimate ability to merge or be acquired, whether it be friendly or hostile.

Senator, that concludes my statement, and I will give any of my unused time to the next speaker, with your permission.

[The complete prepared statement of David M. Roderick follows:]

TESTIMONY OF
DAVID M. RODERICK

Before The
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

March 4, 1987

My name is David M. Roderick. I am Chairman and Chief Executive Officer of USX Corporation. I welcome this opportunity to testify before this Committee Hearing on Hostile Takeovers. This is an issue whose time has certainly come as we are witness to the unfolding scandal of widespread insider trading. The rapaciousness of so many in the takeover game has created a distrust of all involved.

Nonetheless, I start with the basic proposition that our free market requires a legal system that accommodates mergers and acquisitions. Hostile takeovers should theoretically take place only when sound business reasons demonstrate that the acquiror will bring forth a more productive and efficient enterprise than existed with the target company so that the acquisition will contribute more to the wealth of this country than the former ownership could deliver. However, acquisitions should not be a game of roulette run by financial manipulators using and abusing our laws to make a quick profit with no objective of acquiring and running the target company. If a hostile takeover is accomplished in a fair manner that results in increased efficiency of the acquired enterprise, then stockholders and society are the beneficiaries. I do not seek to impede acquisitions that meet those standards.

But I do believe that takeovers have become so abusive and so tilted in favor of the financial buccaneers that remedial action is required. A properly functioning market will allocate capital flows in the corporate sector unless abuses in market information and the relative power of the corporate raiders vis-a-vis the corporate manager so distort the hostile takeover process that the financial structure becomes skewed to reward paper manipulators at the expense of manufacturing endeavor. Out of this distortion there has emerged an acquisition mania where the sole objective appears to be "get rich quick at any cost." The riches seem inordinately excessive for the raiders, risk arbitrageurs, investment bankers, and lawyers, who churn the process without concern for the long-term benefit of the acquired enterprises as ongoing productive operations providing goods, services, and employment for society.

I do not advocate government intervention to prevent mergers and acquisition -- whether friendly or hostile. Rather, I believe that the abuses that have become pervasive should be curbed and the rules modified to make the system fair and equal for both the target company and the takeover bidder. The rules governing hostile acquisitions should assure a neutral market condition that mitigates the advantages which now accrue disproportionately to the raider and very often to the disadvantage of the shareholders of the target company. We seem to have evolved a legal mechanism that allows massive abuses by a small group of raiders, arbitrageurs, promoters, and investment bankers, who reap enormous profits serving only their own self-interest at the expense of stockholders, employees, creditors, communities, and the nation at large.

The quick profits available simply through financial manipulation and legerdemain have created an era of such greed that we are witness to the continuing unfolding of scandalous criminal behavior in the pursuit of making a quick killing. I most certainly want government response to eliminate these abuses without crippling the functioning of the free market by excessive restrictions of mergers and acquisitions. I believe the federal government must seek to prevent such fraud and abuses; I do not, however, suggest that the government legislate draconian restrictions that would be legislated determinations of what is or is not efficient and what is uneconomic because properly structured and sound business acquisitions can benefit shareholders and the country.

We have heard many arguments made supporting the hostile takeover movement either in its present form or an even more liberalized norm. It is usually those reaping the huge riches who most vigorously espouse an easier takeover system. Entrenched, enfeebled, and ineffective management must be disciplined by takeovers is a standard and favorite argument justifying hostile takeovers. Takeovers stimulate effective management and penalize ineffective management is this popular theme of the corporate raiders. This is an enticing argument which to my knowledge has no empirical evidence to support such a proposition. The logical extension of that argument must necessarily be that only badly run companies are the subject of hostile takeovers, and they deserve whatever they get from the corporate raider. I would suggest that this is not the case with the vast majority of target companies. In many instances, the target company is the leader in its field. And in fact, the company has been managed in such an effective manner that it is a very attractive enterprise, which the corporate raider covets. To those who make this condemnation of management, I would ask whether the financial paper pushers have a demonstrated track record that would qualify them to identify inefficient management. And have they manifested their managerial skills so that we can with confidence entrust these financiers with more efficiently and effective running a target enterprise? While the managerial skills of the financiers might remain in doubt, many of them have demonstrated great skill in soliciting and providing insider information that is the subject of grand jury and SEC investigation. This justification for the hostile takeover might be answered by asking a final question: Should corporate America be restructured by financial speculators and by sellers of junk bonds which make takeovers possible?

It is further contended that greater value is created by means of the acquisition and that the target shareholders therefore clearly benefit. It is difficult for us to view the carnage that has occurred in so many of the hostile takeovers and find where the enhanced value can be found. The target shareholders who seem to benefit are the corporate raiders and arbitrageurs who buy into the stock of companies that are put in play. Many of the target shareholders that sell their stock to the "arbs" and the raiders do not normally benefit anywhere near the obscene gains made so often by the financial manipulators and arbitrageurs. To many of us it is hard to find the enhanced value from the fractured and highly leveraged residue remaining after a hostile takeover effort. One must take a longer view of keeping our companies competitive. Instant gratification for the few should not be confused with greater good for the nation is the long run.

The negative consequences of hostile takeover activity flow from abuses tolerated in the present structure. Usually the target company is not the object of an acquisition sought by the raider to: cure inefficiencies, eliminate ineffective management, operate the takeover in a smarter manner, better utilize its capital, and create greater value for the shareholders and the enterprise. I should quickly stipulate that if the hostile takeover is done for and accomplishes those objectives, then we in management do not and should not resist such acquisitions -- we should welcome them. However, I again insist that the present rules governing hostile acquisitions do not encourage those highly desirable consequences. In my opinion, it results in nearly always quite the contrary.

The present system permits corporate raiders to put a company in play under the fiction that the corporate raider is genuinely interested in acquiring the target company. Too often it is a shooting match, where the target is in the sights of trigger-happy profiteers. I believe it is the gamesmanship which permits the greatest abuses to flourish in the takeover area. There is the ostensible desire to buy a target company expressed by a takeover specialist where the proposal is so tenuous and subject to so many prior conditions before a tender offer will be made and consummated that the tactic is not to acquire control of the company but to force a quick profit by encouraging some white knight to come forward and buy the company at a premium to afford a quick, easy, and riskless profit to the takeover specialist and the arbitrageurs. Often the corporate raiders and arbitrageurs simply play the game of buying an equity position in a company, publicizing that fact to put the company in play, and thereby create a frenzied excitement in the stock of that company to seek to drive the stock price to artificially high levels that then permit the arbs and raiders a quick exit from the stock at a very handsome profit. Absent either of those events occurring, there is the quick profit to be gained through extraction of greenmail. In the case of very large hostile acquisition attempts, it is extremely dubious that a highly leveraged hostile takeover can succeed through use of junk bonds. The bona fides of such tenders are highly suspect. To curb these make-believe tender offers, the law should be amended to provide a clear requirement that the necessary financing must be in

place prior to an offer being made. We believe that eliminating the financingout option in tender offers would prevent the sport of putting a corporation in play so the raider, banker, and arbitrageurs can reap big profits when there has never been any real intention of going ahead with a legitimate tender offer leading to the actual acquisition of the company.

Along these same lines, I would require that anyone who purchases more than 10 percent of the stock of a company should be obliged to make an all-cash tender offer for all of the remaining outstanding shares. Furthermore, any tender offer must provide the shareholders with the option of receiving all cash for their stock. Likewise, any hostile tender offer should require that the tender be for all outstanding stock at the same price.

It is not the junk bonds per se that constitute the evil in putting a company in play where a successful takeover is slim to nonexistent. Rather, it is the potential use of the junk bonds by a corporate takeover specialist who has no financing in place but puts a company in play based solely on a purchased "highly confident" letter. The law should be structured to insure that he who plays the takeover game must be sincere and have his financing secure and in place before romancing the takeover target with a tender offer.

The shareholders of the company should have pertinent information available to them on a more timely basis. Under the present legal provisions, a corporate financier can acquire a very significant block of stock before he is required to make such substantial acquisition public by the 13D filing with the SEC. The purpose of the filing is to alert shareholders and the market that there has been a large and rapid accumulation of securities by an individual with the likelihood of a change in corporate control. The corporate raider could theoretically own 10, 20, or 30 percent or more of the stock before the investing public is aware of such a significant event. Obviously, the substantial stock purchased by the raider is stock acquired from shareholders who sold while unaware that a tender offer might be forthcoming. I believe the 5 percent rule and the 13D filing within 10 days has allowed a select group of raiders to gain at the expense of uninformed shareholders. I suggest that the law be modified to require a 13D filing within 24 hours after any person acquires 1 percent or more of the outstanding shares of a corporation. And I would require the same 24-hour filing notice for any subsequent 1 percent change in stock ownership after the initial filing.

Also, I would require that tender offers be open for 40 trading days instead of the current 20 trading days. This greater period would afford shareholders a longer time to make their decision and would afford management a better opportunity to maximize shareholder value by seeking a better price for the stock than the initial tender offer, including seeking to attract a white knight at a higher price.

One of the most important elements in eliminating game playing is to bar the payment of greenmail. The definition of greenmail must be carefully crafted, but it most certainly should include the payment by the target company of the corporate raider's legal fees and investment bankers' fees. The prohibition against greenmail would foreclose the financial manipulator from taking an equity position in a target company and putting it into play in order to extract a quick and dirty profit by receiving greenmail. This would eliminate the corporate raider who never intended to seek control of the company but purchased stock in hope of being bought out.

The adverse consequences of such spurious hostile takeover activity are:

- o undue pressure to manage the enterprise for short-term showing to try to increase the stock price without concern for the long-term consequences;
- o the diversion of top management's energy from running the business to dealing with the takeover;
- o the very significant costs necessarily incurred in the use of investment bankers, lawyers, and other specialists, which is not the most efficient use of corporate money;
- o the pressure to rush into improvident restructuring with long-term adverse effects.

I am concerned that too many hostile takeovers can result in such highly leveraged situations they require an immediate bustup of the enterprise to reduce debt without concern for the most efficient operation of the enterprise. This can result in a myopic compulsion to generate a quick conversion to cash at the expense of the long-term viability of the company. The question must always be asked: Is the acquisition simply to buy a reasonably healthy company and immediately break it up to secure a quick profit for the corporate raider trading on the disembodied profit potential of the pieces of the company without concern for the long-term consequences? This cannot be a publicly desirable result.

Undoubtedly, if American industry gets overleveraged to where the cost of financing is extremely burdensome, future corporate financial flexibility will be reduced, research and development will decline, and a company's ability to create capital investment needed to sustain the enterprise will also decline. And, of course, the dangers of debt default and corporate failures increase with such improvident debt burden. An overleveraged corporate structure in America could lead to long-term problems, especially during periods of business contractions or recessions.

In conclusion, I would summarize by saying that it has been my experience that these changes would help to curb the abuses in hostile takeovers and would foster the best interest of our stockholders by insuring them of prompt information while assuring them of legitimate tender offers. It would protect them against the potentially adverse effects of spurious game playing in the tender offer arena. There remains for this Committee the very important task of ascertaining whether the tremendous merger activity and highly leveraged takeovers pose a problem for not only corporate financing but for the banking system as well.

There are certain abuses that are so apparent that I submit legislative action should be undertaken immediately. I would urge prompt action to prohibit the payment of greenmail; I would require notice to the SEC and the target company within 24 hours after a 1 percent interest in the stock of the target corporation is acquired; and I would require that financing be lined up and secured before a person can propose to make a tender offer. These reforms should be enacted without delay. There are other matters in the merger and acquisition area that require careful study before any legislative action is taken. The effects that merger and acquisition activity may be having on the banking system is such an issue, as is the question of whether highly leveraged corporations pose a problem for corporate well-being; and if these are dangers, careful thought must be given to the proper solutions.

The **Chairman**. Our next witness is Mr. Plank, who is the chairman and chief executive officer of the Apache Corp.—of Denver, CO.

Senator **Armstrong**. Duly noted, Mr. Chairman. [Laughter.]

STATEMENT OF RAYMOND PLANK, CHAIRMAN AND CEO, APACHE CORP., DENVER, CO

Mr. **Plank**. Thank you very much, Mr. Chairman and distinguished committee members. I want to thank you for the opportunity of being here with you today and sharing briefly a few comments apart from the remarks which are available and have been made available to the record.

LONG-TERM RESPONSIBILITY OF CORPORATIONS

You have in your first hearings, demonstrated such a detailed knowledge of this that I have opted to take a slightly different route and merely observe several points which I think are important. Those of us who are chief executive officers and on the boards of other companies, recognize that we have a long-term responsibility to the long-term profitability of our corporations, their shareholders, as well as a long-term responsibility to the other constituencies that we serve.

My father used to point out many years ago that profit was the last dollar made after the other claimants upon the enterprise had been responsibly served.

If we are to deal in the short-term, we have a hopeless conflict of interest, and I really think that the same thing applies to you who are setting policy for this country, in terms of its long-term competitiveness, in terms of the standard of living which we want available to our fellow citizens within the United States of America.

When confronted with a short-term situation in which any of these corporations that you have CEO's here from today, including our own, might be worth more dead than alive, namely, through an asset strip, we would have the responsibility to our shareholders to liquidate that enterprise. Invariably, the situation is where the raiding company comes in, seeks to restructure, strip the assets, pay down the debt, discharge employees.

In our energy field, for example, we have three parallel situations. We are subject to the inroads of trade imbalances, we are very much affected by it. We are subject to a change of policy with respect to the vitality or the importance of our industry to the Nation's long-term energy security, and then we are subject, more than any other single industry, to the raids of the hit artists.

All three of those are, in my opinion, contrary to the long-range interests of the United States.

I would like to suggest that where I am thrilled that Mr. Boesky has served as the trigger, along with Mr. Levine and Mr. Siegel, for this outstanding focus and for the truly great investigatory work that has been conducted by effective public servants. But we have just pierced the veil of this. The snake has been attacked in its middle. We are dealing so far merely with part of the means to an end, but we need to look at the source as well as the other people who are sharing the same kind of benefits and rewards which run into the hundreds of millions of dollars which are symptomatic only.

GOES BEYOND THOSE ALREADY INDICTED

It goes way beyond the Boeskys and the arbitrageurs. It goes to the investment bankers, as Mr. Roderick has noted, to some of the investments firms and certainly to the lawyers. But the ending behind it all is those practitioners who have got enough guts to stand up and attack managements of the corporations who do contribute to the long-term well-being of the people of the United States, indicate they're no good, even permit that capacity to be inherited by their children, who, at 30 years of age, in one instance, I note, is now attacking a Japan fund, selling at a discount, for a mere modest beginning allowance to "Sonny Boy" of $500 million.

That is going a little far in this country, in the name of free market. It is not free market. It is elimintion of our capacity to compete.

Senator Armstrong, last week we noted the playout of Kaiser Steel. The company had been in play years ago. $100 million had been stripped out of the assets, basically, by the first owner. It had been turned over to a second owner. The company entered bankruptcy.

That puts additional pressure on you and on the very effective Governor Romer of my now State of Colorado. Some of the testimony that came out was that the shortage for the medical benefit funds, as well as for the pension funds of the 8,000 current and former employees would run somewhere between $200 million and $600 million. Those jobs disappear and the social costs of the State of Colorada rise, short-term or long-term.

I would urge you, gentlemen, to look beyond merely how you close the window on the arbitrageurs. Strike at the root of it and then we will have down a great deal to even the playing field.

I think one of the best ways of doing it could be, among other things, to require an impact statement on every constituency affected, along with the suggestions that they demonstrate adequate financial capacity at the outset, not only to deal with the shareholder interests but also to deal with the reduced credit risk—the higher credit risk, the reduced creditworthiness that is forthcoming, so far as the bond and debenture holders are concerned.

Thank you very much. I will be pleased to answer any questions that you may have.

[The complete prepared statement of Raymond Plank follows:]

The CHAIRMAN. Thank you, Chairman Plank.

Our next witness is from Milwaukee, WI. He is chairman and CEO of the Universal Food Corp., Mr. Murray. Go ahead, Mr. Murray.

STATEMENT OF JOHN L. MURRAY, CHAIRMAN AND CEO, UNIVERSAL FOOD CORP., MILWAUKEE, WI

Mr. MURRAY. Thank you, Mr. Chairman. I am pleased at the opportunity to address your panel this morning. I would like to do so in these brief remarks from the point of view of the CEO of a modest-sized publicly held company, 105 years old, having an excellent long-term growth record. I would like to discuss a little bit about how we see this current situation.

We do have plants in Wisconsin, California, Texas, and New York, for those representatives on your panel who are from those States.

We have always managed our company with a very sensible debt ratio, about 35 percent debt 65 percent equity. We have, and every employee has in their possession a definition of what we are trying to do, which says that customers are to be well-served, profits are to be fairly earned in the competitive marketplace, investors are to be rewarded, employees are to have help in growing in their careers and the needs of the communities in which we are domiciled are to be recognized by appropriate commitment of corporate time and wealth. And that isn't some phrase drafted for this panel. That has been a guiding force of our company for a long, long time.

Does any of that worthwhile constructive activity suggest that I or my management team should be spending time becoming masters of poison pills and super majorities and leverage ratios of 10 to 1 or 100 to 1 and common stock with different voting rights, et cetera? And where are we to go on Wall Street for advice from investment bankers, when we know that a major portion of their income today is made from stirring the takeover pot and either directly or inadvertently putting companies into play?

DIVERSION OF ATTENTION FROM OPERATION OF BUSINESS

The management of a company is a full-time task, and it is painful to see senior management teams struggling with takeover problems and related defenses and diverting their attention from the direct operation of their businesses.

I hope all of you will recognize the lack of logic in case law today which suggests that a company is expected to participate in its loss of independence, whether negotiating for a higher price or seeking white knights, et cetera, just because some unwelcome purchaser has indicated they want to buy the company. If that is prudent conduct, then isn't it the height or irresponsibility for directors to await the chance call from an unknown company, when, with preplanning, they could define a substantial universe of companies who would be willing to participate in buying them, if invited to do so?

But if all public companies are to be continuously for sale, to whom are they to be sold?

The madness of the present situation and it's applicable rules would be humorous, if they didn't pose so serious a threat to our Nation's economic health and its worldwide competitive position.

I believe very strongly in the potential benefits of soundly conceived negotiated acquisitions. Our company has participated in more than 45 of them over the last 25 years, and as a result, our revenues have grown from $6 million to $600 million, with excellent rewards for long-term investors. But in every acquisition that we have participated, the relationship has been friendly, our due diligence investigation always spans many months. And includes a comprehensive examination of plant facilities, fringe benefit programs, computer controls, detailed evaluation of the respective companies' corporate cultures, et cetera.

In every case, there had to be sound reason for the acquisition, other than executive egos concerned only with the size of their managerial fiefdom.

I find it ridiculous to assume that companies can bid vast premiums over market prices for other companies, for which they have no more detailed knowledge than that which is contained in the target company's annual report and 10K. The sketchy research that is in existence suggests that acquiring companies in those cases rarely earn their cost of capital on such acquisitions, even with the passage of many years. The selling shareholders take their premium and run, but the shareholders of the acquiring company get stuck with the ill-advised purchase.

Based on the limited amount of research available to date, it probably should be the case that it is more important that the shareholders of the acquiring company in an unfriendly tender offer should have to bless their management's action.

The other type of such acquirers, syndicates of fast-buck artists rarely operate the companies they acquire. Instead they break them up and sell off pieces, all part of one gigantic financial maneuver.

But perhaps the height of ridiculousness has just been evidenced in our home State, Mr. Chairman. A Wall Street Journal article of 1 week ago suggests that there is currently an attempt to put into play one of the prime companies in Wisconsin, Harnischfeger Corp., by a real estate developer, whose 19-year-old son during his college vacation identified the prospect.

Now if Wall Street was acting responsibly, they really wouldn't take seriously recommendations of 19-year-old kids on summer vacation playing with their personal computers. Somehow we must return to a sensible situation, and I believe the recommendations that are contained in my prepared remarks, dealing with the vesting of all employee benefits in unfriendly tender offers, the restrictions on raiding pension plans, and the suggestions for improving the rights of existing debt holders in unfriendly tender offers, are all appropriate and ethical steps to be taken.

Along with the many other recommendations you have received and will receive, I believe such actions will go a long way to permit U.S. management to return to the business of managing their companies.

Mr. Chairman, fellow committee members, I thank you for your attention.

[The complete prepared statement of John L. Murray follows:]

TESTIMONY OF

RAYMOND PLANK

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

APACHE CORPORATION

BEFORE THE

COMMITTEE ON BANKING,

HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

MARCH 4, 1987

Mr. Chairman and Committee Members, I thank you for the opportunity to appear before you today. Having watched a video of your initial hearing, I was pleased to note both the grasp of facts and detailed knowledge of Senator Proxmire, other members of the committee and early witnesses on your panels. Given earlier hearings, my remarks seek new ground.

To me, as chief executive officer of a NYSE listed company with over 20,000 shareholders and 100,000 investors in oil and gas partnerships, I would note parallels between the responsibilities of corporate directors and officers on the one hand and our Federal government on the other. Corporations bear long term responsibility both to their shareowners and to each of multiple, interdependent constituencies. My father put it well fifty years ago. 'Profit,' he said, 'is what you have left after you meet your obligations to everyone else." Government bears long term responsibility to the United States and its citizens.

If the directors and I as founder and CEO of Apache look to the short term, takeover wisdom would suggest the company be liquidated, employees terminated, our contribution to the nation's energy security and hope for the future ignored.

If you, as members of the U.S. Senate look solely to fallen energy prices as a brief contributor to relatively flat inflation statistics, you too can ignore the current erosion of American energy security, of lost jobs, mounting trade deficits, eroded international competitiveness.

For whether it be $170 billion dollar trade deficits, or forfeited energy security, or American corporations' forced liquidation each in the name of administration and corporate raiders' "free market hullabaloo", the effect is the same. The nation's long term well-being is held hostage to short term benefits for the greed-driven few.

Corporate governance and the Congress are confronted with irreconcilable conflict when asked to march to short term drum beats on the one hand and our long term responsibilities on the other.

This administration has ignored and allowed responsibility to its citizens to be interdicted by elements foreign and hostile to our long range interests, whether they be in trade policy, energy security, or takeover mania.

Nowhere has it been recently more evident than thru the syphoning of hundreds of millions of dollars of rightful share owner values by insider arbitrageurs. Thank God, America is given the opportunity to reflect and recoil when a handful of insiders are slapped into handcuffs and hauled away. The fines and prison terms to date have been anticlimactic.

Even though the veil of massive takeover scams has been pierced, it's only one link in the chain. As an earlier witness testified, the motive is greed. To which I would add, the out-front takeover predators are the source, the arbitrageurs, the yet unchallenged bankers, investment bankers, lawyers who participate on both sides of the takeover game are the lavishly paid retinue, and the long term interests of these United States are the victims.

Should you concur in this assessment, the path to dealing with the causes and abuses becomes clearer. The remedies, to be effective in the long term, need remedy the causes. Insider trading is but one symptom like the Iran contra affair, of a much deeper malady.

But first, more facts. Hearings have requested further evidence of negative results from hostile takeovers. In the short term effect of the hostilely raided Kaiser Steel, the shareholders received a premium above market, although those putting Kaiser in play, and those stripping the assets benefited disproportionately. Years later, on February 13, 1987, our headquarters' Denver papers and the

New York Times alike noted, "Kaiser Steel Files Chapter 11 Petition". The Times proceeded, "The debt to Kaiser's 8000 current and former employees in lifetime pension and medical benefits alone could total between $200 million and $600 million depending on actuarial standards, according to Craig A. Cristensen, Kaiser's bankruptcy lawyer." Colorado's alert Governor Roy Romer loses more jobs, more tax base, and incurs, as does the Congress and President of these Untied States, more unreimbursed social costs.

Nowhere have hostile takeovers and cliche "restructuring" devastated a contemporary and fading U.S. industry harder than the oil and gas industry. Notorious domestic forays by takeover specialists, spouting free market gospel, coupled with cartel oil pricing have driven an industry vital to our national security perhaps below its subsistence level. As a 35-year participant and witness, I should know. Take Phillips Petroleum. A weaker, debt-ridden, research, exploration and drilling, and employee reducing but wounded company survives without credit to its predators. Yet the predators weren't satisfied with one run at the company. The takeover specialists hit it in waves after the first attack was fought - or bought off in a settlement which called for a standstill agreement by one party, but was not binding upon the next charge. Investigators could do well to trace down the company's observation that after Pickens, an alert investment banking firm "shopped the deal" for the second onslaught. Members of this firm figure prominently in the current insider investigations, fines, and guilt admissions.

It's fine to strike at arbitrageurs through tightened insider trading rules.

It's fine to take away the tax subsidy of deductible junk bond interest, and to shorten the disclosure period to one or two days following the 5% disclosure threshold.

But do those valid measures really strike at the long term cause, or merely deal with certain of the effects?

After all, capital flowing in 1986 into mergers, leverage buyouts, acquisitions, stock buy backs, much of it in the form of debt substituted for equity totalled $150 billion (1). That sum exceeded total investments in productive plant and equipment of $140 billion (1) for

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(1) Gallagher Report 11/86.

the first time. 135 banks failed, many from energy, agriculture, real estate and commodity deflation. 150 bank failures are estimated for 1987, with the geographic areas largely in energy states.

The February 13 New York Times headlines also noted, "Schlumberger Loses $2 Billion" in the fourth quarter. Energy-driven again. Banks' energy losses and non-performing domestic and international energy loans have been estimated at $70 billion - a sizeable sum even against $200 billion Federal deficits.

In 1986, Mr. Chairman, $41 billion went into 32 mega (1) mergers, many takeover-driven. This sum was 1300% of all new venture capital commitments reported in '86. It was double the $22.4 billion raised from initial public offerings, and 717 young, entrepreneurial companies raised but half the funds used in 17 hostile-driven deals.

Please don't stop with insider reprimands. Let the raider and defender forego greenmail. Don't let the practiced raider get by with the assertion his first hit is "for investment purposes". Close the loophole of the shareholder - stampeding two-tier or series tender. Require the hit man to file an impact statement of his game plan on employees their retirement funds, upon the communities, customers, suppliers, and debt holders lest assets be stripped and constituencies robbed.

Then, and then only, will the long term considerations of hostile takeovers and their unreimbursed social costs be equated against short term avarice or indifference of those proclaiming "free market, free market".

Thank you.

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(1) Wall Street Journal 1/2/87.

The CHAIRMAN. Thank you very much, Mr. Murray.

Our next witness is George Slocum, president of the Transco Energy Co. of Houston, TX. Go ahead, Mr. Slocum.

STATEMENT OF GEORGE S. SLOCUM, PRESIDENT AND CEO, TRANSCO ENERGY CO., HOUSTON, TX

Mr. SLOCUM. Thank you, Mr. Chairman. Even though Senator Phil Gramm of Texas is not here this morning to brag on us, a brief look at Transco's latest annual report, would show a company with total assets of $4 billion and a current market value of just under $1.5 billion. We have almost 5,000 employees in our three core businesses—natural gas, transportation and marketing, oil and gas exploration and production, and coal production and marketing. And our operations are located in the gulf coast and eastern seaboard States.

My 8-year experience at Transco has coincided with some of the most challenging and turbulent times in the energy industry. You name it. Shortages and excesses. Regulated prices and deregulated prices. Dramatic price swings up and down and rampant merger and acquisition activity. Why, to me, it is almost as exciting as the political arena itself. Just as you have survived and done well, however, so has Transco, even though we have been run through the takeover mill several times.

VIEWS ON TAKEOVER ACTIVITY

I welcome this opportunity then to present the committee with Transco's views on this takeover activity, especially as it affects the energy industry. Let me say right up front, that I am not an anti-takeover critic. Transco is for sale every day on the New York Stock Exchange. If an investor group wants to buy our company, provided it offers a full and fair price and is deemed by the directors to be advantageous to all shareholders, Transco is sold. However, there are two points I would like to impress upon you today in the limited time I have.

First, I am against certain unfair practices that appear to give the takeover bidder a distinct advantage, once a target company is put in play.

Second, when an energy company which is heavily involved in domestic oil and gas exploration development activities is taken over or restructures its capitalization with substantial additional debt as an alternative value enhancement step for its shareholders in the short run, it invariably has the resultant effect of preempting the allocation of risk capital to oil and gas drilling budgets. That, of course, may be relatively inconsequential to you in isolation, but when such an outcome occurs many times over, as it did 55 times in the 5-year period through the end of 1986, we feel it can potentially have adverse consequences for this country's energy security.

Let's talk briefly about my first point of assuring that there are rules of fair play that protect the rights of all parties and interests alike, existing shareholders and prospective shareholders. The dynamic forces within the energy industry and the capital markets have encouraged the consolidation and company restructuring activities that have been so intensive these last several years.

Transco itself has heen an active participant in seeking value enhancement for its shareholders, first by forming a publicly traded exploration partnership in 1983, purchasing a major coal production and marketing company in 1985 and making two smaller acquisitions last year. What is needed, especially in the M&A acquisitions involving entire companies, is a more reasonable timeframe and opportunity to allow the shareholders to evaluate, and the target company to develop and adequately communicate to its existing shareholders, fair or more fully priced valuation alternatives. If this more rational, equitable practice eliminates the gun to the head environment that has been the norm due to 20-day tender offer periods and arbitrageurs, apparently often with inside information, that storm into majority shareholder positions, so be it.

We say, let's level the playing field for the benefit of all concerned. Everyone deserves a fighting chance. After all it is our employees, customers, producers, communities, et cetera that are all parties in interest in these changes in corporate life transactions.

Specifically, we recommend consideration of the following remedies, at a minimum:

First, extend the mimimum offering period under the Williams Act from its current 20 business day level to 90 days or about 3 months. This extended period should give the shareholders the opportunity to fully evaluate the offer and significantly enhance the target company's efforts to develop a preferred shareholder alternative.

Second, we feel you should disallow creeping tender transactions, as they are called, whereby any person increasing his ownership over 5 percent must notify the target company within 1 day and should only be permitted to add to his ownership by way of a fully financed public tender offer. All remaining shareholders should have the opportunity to receive a premium value for effective control of a corporation.

The energy industry is one of only a few industries with long lead times for returns on productive investments. In our industry, there is a tradeoff between short-term asset or reserve liquidation and longer term capital investment in replacing production with proved oil and gas reserve additions.

It is increasingly likely that the aforementioned numerous takeovers and restructuring that have taken place in our industry will have a counterproductive impact on the country's domestic oil and gas reserve position. Consequently, if there is any industry that needs a more level playing field with respect to tender offer time periods and protection from creeping takovers, it should be a cash flow or asset-intensive industry, such as energy.

In conclusion, Transco believes the time has come to rethink and revise the rules of the takeover game. For reasons of energy security and a sense of fair play, we believe that time is now.

Thank you.

[The complete prepared statement of George S. Slocum follows:]

A quick review of 1986 domestic exploration and development programs for several of the major energy companies, which have undergone recent restructuring, indicates a budget reduction of over $4 billion as compared to their respective 1985 levels. Consequently, if there is any industry that needs a more level playing field with respect to tender offer time periods and protection from creeping takeovers, it should be a cash flow or asset-intensive industry such as energy.

In conclusion, Transco believes the time has come to rethink and revise the rules of the takeover game. For reasons of energy security and a sense of fair play, that time is now!

Thank you.

1] Reference: A Review of Oil and Gas Journal "400" Oil and Gas Companies, 1982-1986.

2] Reference: Arthur Anderson & Co. 1985 Survey of 375 Public Companies.

The Chairman. Thank you very much. Our next witness is Mr. Andrew Sigler, chairman and CEO of the Champion International Corp. of Stamford, CT.

STATEMENT OF ANDREW C. SIGLER, CHAIRMAN AND CEO, CHAMPION INTERNATIONAL CORP., STAMFORD, CT.

Mr. Sigler. Mr. Chairman, I too want to thank you for the opportunity to be here. Because of the shortness of time, I would like to add my support in general to the statements that have been made and maybe add one or two thoughts on it.

I think one of the important things is not to deal with the myths and the theories but to deal with the absolute facts of how the takeover game is played, because I think you will find a great difference.

We have yet to have a takeover where the good guys threw out the bad guys and managed the company into the sunset for the prosperity of everybody. All of the defensive mechanisms, and this has been mentioned before, are not only negative to the companies, but are also negative to the economic system.

CHANGING NATURE OF SHAREHOLDERS

I would like to focus today on the changing nature of shareholders. One of the key defenses that Senator Riegle asked us to respond to was the potential gain to the shareholder. We are told that if a shareholder gains, then a lot of things can be condoned.

Let's take a look at who these shareholders are. The New York Stock Exchange has somewhere between a half and a third of all of its equity owned by institutions. In the case of Champion, and I think we are typical of our kind of company, roughly 75 percent of our shareholders are professionally managed portfolios of institutions. They are part of the approaching $2 trillion that is essentially ERISA-mandated money, two-thirds of it being in the private pension fund area. The bulk of the rest is in the public pension fund area.

Let's take a look from Champion's perspective at who my shareholders are. Somewhere between 15 and 20 percent are traditional index funds—funds which buy stock based on a computer model that will maneuver the assets of that fund in relationship to the S&P 500 Index. Somewhere in the same neighborhood of 15 to 20 percent of my shareholders are the result of the program buying and selling that has now been made reasonably public.

So fully a third of my shareholders at any one time bought the stock without any human knowledge and, because of the way the system works, really don't care whether that stock goes up or down, as long as it tracks the index. If you take this thing called noncompany specific industry weighting, which means you weight a fund based on an industry need and pick companies based on a rather mechanical formula, maybe that number of nonhuman shareholders reaches a half.

I have very few long-term shareholders who are interested in the company at any given time. When a company goes in play and arbs buy, the longer term individual shareholder tends to sell to the arb. Those are the shareholders who tell us that we should forget all of the management things that my fellow panelists here have talked about, so they can make a dollar.

The ultimate irony is that the aggregate of the institutional management of pension funds is a nonvalue-added industry. If you will look year after year, their total performance is equal to a number of the market index averages less their fees, and it can't be any way else because they are the market today.

The other irony is, most of us have what are called defined pension plans, where the company has an obligation to make a specific payment. It doesn't make any difference what the fund does as far as the individual person in the plan is concerned. All that it makes a difference to is what the company's contribution to that plan will be over the succeeding years.

We have in these funds the most concentrated economic power that has ever been. They are the ones that buy the stock and sell the stock. They are also the principal funding for the so-called junk bonds.

A disturbing fact being made public now on the New York City pension program is that its leader is a man who testified here last year that these pension plans should be given more authority and more respect as shareholders. Now it appears he may have had a relationship in the maneuvering of stock, as the game is played.

So I second the other comments made about the asset-stripping takeover artists being the most anticompetitive pressure that has been put on this economic system ever. We need to change the regulations to bring a sensible process into what is a rather violent activity in the economy.

Thank you.

[The complete prepared statement of Andrew C. Sigler follows:]

TESTIMONY OF

JOHN L. MURRAY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
UNIVERSAL FOODS CORPORATION

BEFORE THE

COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

March 4, 1987

Mr. Chairman, thank you for the opportunity to testify this morning. The business community applauds you and your colleagues for holding these Hearings. I believe that similar applause is coming from organized labor, from working men and women throughout this Country, from equity investors, corporate creditors, and from the public generally.

Mr. Chairman, I believe that all Americans agree with your statement which opened these Hearings on January 28, 1987:

> ". . . corporate raiders, who produce little, but trade a lot of paper, make off with tens and sometimes hundreds of millions of dollars, while leaving thousands of corporate employees out of work."

Americans have seen all they ever hope to see of suitcases of cash being transferred on Wall Street. The behavior of Messrs. Levine, Boesky, Seigel, and probably others still to be named who have been hostile tender offer role players, will have an enormous negative impact on our capital markets.

As the Chief Executive Officer of a modest-sized, publicly-held company, I am extremely pleased at the opportunity your Committee has afforded me to give you my personal views on what is wrong with the hostile takeover phenomenon as it is practiced in this Country today -- and to share some of my thoughts on what ought to be done about it.

To begin with, statistical data suggests that once a company is "put into play" (and isn't "put into play" an interesting bit of Wall Street terminology for so serious an activity), the company will, for all practical purposes, lose its independence then or within a short time thereafter. Case law suggests Boards have an obligation to deal with unsolicited offers on the ground that such activity might prove beneficial to stockholders. But if this has merit, why shouldn't all Boards of Directors of all companies be required to continuously "shop their companies"? Why should contact from an unwelcome suitor be the sole triggering device? The fact that a company hasn't been tendered for shouldn't indicate to a Board of Directors that there aren't a vast number of companies who would like to buy it should it put itself up for sale.

I believe that the Congress should focus its attention on unsolicited tender offer attempts. Congress should recognize the lack of logic, even madness, in case law which suggests a company is expected to participate in its loss of independence (negotiating for a higher price, seeking white knights, etc.) just because some unwelcome purchaser has indicated they want to buy the company. If this is prudent conduct, then it is the height of irresponsibility for Directors to await the chance call from an unknown company when, with preplanning, they could define a substantial universe of companies who would be willing to participate if invited to do so. But if all companies are for sale, to whom are they to be sold? The madness of the present situation and the applicable rules would be humorous if they didn't pose so serious a threat to our Nation's economic health.

I believe very strongly in the potential benefit of soundly conceived negotiated acquisitions. My company has done over forty-five of them in the last twenty-five years. As a result, our revenues have grown from $6 million to $600 million in that period with tremendous rewards to our long-term investors. In every acquisition in which we have participated, the relationship has been friendly. Our due diligence investigation always spans many months and includes a comprehensive examination of plant facilities, the status of fringe benefit programs, the existence of computer controls, and a detailed evaluation of the respective companies' corporate cultures. In every case, there had to be sound reasons for the acquisition other than executive egos concerned only with the size of their managerial fiefdom.

I find it ridiculous to assume that companies can bid vast premiums over market prices for companies for which they have no more detailed knowledge than what is contained in the target company's annual report and 10-K. The sketchy research in existence suggests that the acquiring company rarely earns its cost of capital on such acquisitions, even with the passage of many years. The selling shareholders take their premium and run, but the acquiring company's shareholders get stuck with the ill-advised purchase. Based on the limited amount of research available to date, it probably should be the case that the shareholders of the acquiring company should have to bless their management's action. The other type of acquirers, syndicates of fast buck artists, rarely operate the companies they acquire but, instead, break them up and sell off pieces, all as part of one gigantic financial maneuver.

Having been involved in more than forty-five acquisitions, I would like to discuss some of the factors that are ignored in hostile takeovers, all of which have substantial repercussions on our Nation's economy and its workforce.

Let's begin with employees.

Employees incur substantial risks when a target company is acquired in a hostile takeover. Where synergies can be achieved and an operation made more efficient, I or any other executive would endorse such activity; but the hostile takeover artist invariably is so laden with debt that plant closings, the stripping of assets, and pension plan raids are almost always driven by the need for cash to repay debt rather than long-term, prudent operating business decisions. Accordingly, I think an appropriate recommendation would be that all employees, regardless of years of service, have their respective years of service vested at the time their company is acquired if their Board of Directors does not vote positively to endorse the acquisition.

Another recommendation to protect employees in hostile takeovers would be that excess funding in the pension plan could not be removed for a period of three years. This recommendation is based on the fact that the target company's regular Board of Directors did not find it judicious to remove such funds out of a concern for the long-term fiscal health of the pension plan. Raiders, on the other hand, are burdened with massive amounts of debt, lack the same degree of concern for the employees of the target company, and have, as their greatest concern, the repayment of debt. Excess pension funds are viewed as an attractive solution to their problem. To protect the employees, I believe it would be prudent to mandate restraint in those situations.

A final recommendation dealing with protection of employees would be to permit the target company's pension plan portfolio managers to invest in the stock of the target company and, to the extent of that specific involvement, the trustees' fiduciary responsibility should be defined as what is in the best long-term interests of the employees. It is the employees who, in truth, own the pension fund so, clearly, a trustee of a target company's pension plan, who discharges his fiduciary responsibility by selling to the highest bidder because it adds a few extra points to his yield calculation, has not served the employees of that pension plan if the purchaser of the stock fires the employees and closes the plant. The employee values his job more than a few added points of yield in the pension plan.

The rights of existing debt holders of the target company are a separate area of concern. Considerable evidence indicates that existing debt holders of a company taken over in a hostile tender offer have their position prostituted as a result of the retirement of most of the underlying equity and the substitution of a vast amount of new debt, either at an equal or superior position to that of the existing debt. The prior lenders clearly would not have made the loans and agreed to the terms if the restructured balance sheet had been known to them. Where it is legal to put those previous loans in a subordinated position, is it ethical or morally correct to do so? Accordingly, I recommend that existing debt holders be provided the right to "put" their debt to the Company upon the event of certain triggering developments. One such development would be a hostile takeover where the target company's Board of Directors didn't approve the transaction.

These recommendations have the merit of putting acquisitions on solid, logical and ethical grounds. That is the goal of every Chief Executive Officer in this room. I hope that, working with you and your counterparts in the House of Representatives, we can achieve that goal.

If we do not, Mr. Chairman, then I share your fear that America's ability to produce and compete in worldwide markets will be severely -- and perhaps permanently -- wounded.

Mr. Chairman, I agree with Warren Law of Harvard -- whom you quoted in your statement. If the focus of America's economy continues to be on "playing games" -- if "good managers are forced to spend time in unproductive ways, to avoid being raided, rather than (on) activities of social benefit" -- then the day when American enterprise is the engine that drives the Free World's economy is surely over.

It will be a tragedy if those of you in this room -- who have the power to prevent that tragedy -- do not in fact do so.

Thank you, Mr. Chairman and Members of the Committee.

I would be happy to respond to your questions.

TESTIMONY BEFORE THE SENATE BANKING COMMITTEE
MARCH 4, 1987

I am George S. Slocum, President and Chief Operating Officer of Transco Energy Company, which is a publicly traded, diversified energy company based in Houston, Texas. A brief look at our latest annual report would show a company with total revenues of $3.7 billion, total assets of $4.3 billion and a current market value of about $1.4 billion. We have almost 5,000 employees in our three core businesses of natural gas transportation and marketing, oil and gas exploration and production, and coal production and marketing. Most of our operations are in the Gulf Coast and Eastern Seaboard states.

My eight-year experience at Transco has coincided with some of the most challenging and turbulent times in the energy industry. You name it: gas shortages and excesses, regulated prices and deregulated prices, dramatic price swings up and down, and rampant merger and acquisition activity. Why, it's almost as exciting as the political arena! Just as you have survived and done well, so has Transco, even though we've been run through the takeover rumor mill several times. The common explanation for this ability to cope with change and come out a winner over time is that we both, for the most part, tend to make the most out of what we've got--problems and opportunities--for the benefit of our constituents, voters and shareholders alike. Were that not the case and some other candidate or investor/management group could do it better, they would have the right to take over in a fair election at the ballot box or at the tender offer depository, respectively.

I welcome this opportunity to present the Committee with Transco's views on this takeover activity, especially as it affects the energy industry. Let me say right up front that I am not an anti-takeover critic. Transco is for sale every day on the New York Stock Exchange. If an investor group wants to buy the company, provided it offers a full and fair price and is deemed by the directors to be advantageous to all shareholders, Transco is sold. However, there are two points I would like to impress upon you today. First, I am against certain unfair practices that give the takeover bidder a distinct advantage once a target company is "put in play." Second, when an energy company, which is heavily involved in domestic oil and gas exploration and development activities, is taken over or restructures its capitalization with substantial additional debt as an alternative value enhancement step for its shareholders, it invariably has the resultant effect of pre-empting the allocation of risk capital to oil and gas drilling budgets. That, of course, may be relatively inconsequential in isolation, but when such an outcome occurs many times over (such as occurred 55 times in the five year period through the end of 1986),[1] it can potentially have adverse consequences for this country's energy security.

Let's talk more about my first point of assuring that there are rules of "fair play" that protect the rights of all parties in interest alike, existing shareholders and prospective shareholders. The dynamic forces within the energy industry and the capital markets have encouraged the consolidation and company restructuring activities that have been so intensive these last several years. Transco has been an active participant in seeking value enhancement for its shareholders by forming a publicly traded, exploration partnership in 1983, purchasing a major coal production and marketing company in 1985 and making two smaller acquisitions last year. What is needed, especially in the M&A transactions involving entire companies, is a more reasonable time frame and opportunity to allow the shareholders to evaluate, and the target company to develop and adequately communicate to its existing shareholders, fair or more fully priced valuation alternatives. If this more rational, equitable practice eliminates the "gun-to-the-head" environment that's been the norm, due to 20-day tender offer periods and arbitrageurs, (apparently often with inside information), storming into majority shareholder positions, so be it. Let's level the playing field for the benefit of all concerned. If a bona fide offer is clearly the best alternative for shareholders, the free market forces will ultimately see that outcome prevail irrespective of poison pills, super-majority provisions and other structural defenses. Everyone deserves a fighting chance; after all it is our employees, customers, producers, communities, etc. that are all parties in interest in these "changes in corporate life" transactions. Specifically, I recommend consideration of the following remedies, at a minimum:

1) Extend the minimum offering period under the Williams Act from its current 20 business day level to 90 days or about three months. This extended period should give the shareholders the opportunity to fully evaluate the offer and significantly enhance the target company's efforts to develop a preferred shareholder alternative.

2) Disallow "creeping tender" transactions whereby any person increasing his ownership to over 5% must notify the target company within one day and should only be permitted to add to his ownership by way of a fully financed public tender offer. All remaining shareholders should have the opportunity to receive a premium value for effective control of a corporation. Here, too, the shareholders should have the benefit of affording a company's management and directors the opportunity to seek alternative value enhancement measures or provide the shareholders with a better understanding of realizing any potentially higher intrinsic values in their holdings.

The energy industry is one of only a few industries with long lead times for returns on productive investments. In our industry there is a tradeoff between short-term asset or reserve liquidation and longer term capital investment in replacing production with proved oil and gas reserve additions. It is increasingly likely that the aforementioned, numerous takeovers and restructurings that have taken place in our industry will have a counter-productive impact on the country's domestic oil and gas reserve position. Even if oil and gas prices were to increase dramatically in the short run, many of these affected companies would not have the excess or discretionary capital availability to participate in an upsurge in domestic drilling. Transco has seen several of its traditional partners fall victim to severely reduced exploration budgets in the aftermath of takeover battles. For an industry that in 1985 spent about $32 billion to replace just under two-thirds of U.S. oil and gas production, the loss of several billion dollars of risk capital for annual drilling budgets indeed could be counter-productive.[2] It also could be further evidence of this country's allowing supposedly free market forces to put us further into the dominant control of OPEC countries.

STATEMENT OF ANDREW C. SIGLER

BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
March 4, 1987

My name is Andrew Sigler and I am the Chairman and Chief Executive Officer of Champion International Corporation, headquartered in Stamford, Connecticut. Until earlier this year, I also served as the Chairman of The Business Roundtable's Task Force on Corporate Responsibility. As a result, I have had the opportunity to observe the takeover situation very closely. In fact, I watched three hostile raids on the St. Regis Corporation before they were forced to turn to Champion as a "white knight."

During the 99th Congress I testified before this committee and also before the House Energy and Commerce Committee on the subject of hostile takeovers and my message has not really changed; it has simply intensified. I believe that the unfettered buying and selling of U.S. corporations solely for the purpose of financial speculation and profit is one of the most destructive phenomena of the 20th century. As a result, we are seeing the destruction of wealth-creating enterprises that were built over many generations.

Given that all of the witnesses before you today are CEOs of medium to large-sized corporations, it would be easy to discredit our testimony as the self-serving statements of those who are simply interested in protecting our own jobs. However, we are the ones who live with the problems resulting from the ever-present threat of hostile takeovers on a day-to-day basis and I hope that our insights based on this experience can be of some help to you.

As corporate managers, we recognize that many of the hostile takeovers attempted today are not in the long-term best interest of our shareholders, our employees, or the corporation itself as an ongoing economic enterprise. However, this situation presents us with some rather unacceptable options. It is extremely difficult for a company to maintain its competitive position in international and domestic markets and, at the same time, protect itself against harmful takeover attempts. If a corporation invests money in the future -- for example, in research and development, in modernization, in planting trees, or in searching

for new oil and mineral deposits -- it is not maximizing shareholder value in the near term. The result is that the company makes itself a likely takeover target. On the other hand, those measures which are most successful in defending against takeovers require corporate managers to focus almost solely on the short-term. Much of the restructuring and over-leveraging taking place in corporate America today endangers the future competitiveness of these corporations.

As a result of both the takeover attempts of corporate raiders and the defensive measures adopted by corporate management, equity is being removed from our economic base at an alarming rate. In 1986 alone, it has been estimated that corporate debt increased by $200 billion, while corporate equity shrunk by $100 billion. Some have labelled this concern about increased leverage old-fashioned and overly cautious. They claim that high debt is the new way of doing business for the 80s. But the equity in U.S. corporations is the basic underpinning of our economic system. Increased leveraging may provide a short-term boost to a corporation's stock price, but when the funds are not used for entrepreneurial activities such as investment in plant and equipment, the debt serves no long-term sustaining purpose and can cause serious damage to the future enterprise.

While almost every corporation in America is diverting some time and attention to the threat of takeovers, the situation worsens dramatically when a company becomes an actual target of a takeover attempt; the operation of the business is virtually placed on automatic pilot. We find that all employees, not just management, are distracted from the business at hand. Countless hours and millions of dollars are spent in a battle that serves no purpose other than to provide spectacular financial profits for the corporate raider and the handful of financial arbitrageurs with whom he is working.

Other witnesses here today have or will describe the problems in the current securities laws which govern takeovers. I would like to take this opportunity to focus on a difficult and more intangible problem -- the changing nature of shareholders.

In the past several decades we have seen a remarkable change in the makeup of the shareholder population of large corporations. It has been estimated that over 50 percent of the shares of corporations listed on the New York Stock Exchange are owned by institutional investors. And if one looks at trading volume rather than ownership, that percentage is even higher -- approximately 72 percent of NYSE shares were traded by ingrained in our society. Yet the current takeover craze raises the question of whether a financial speculator who buys today and sells tomorrow with no interest in the ongoing enterprise, should be able to exercise the same rights as a property owner. Should they solely control the ultimate decision to end a corporation's existence?

Efforts to limit the rights of short-term shareholders to make such decisions, such as imposing a waiting period before full voting rights convey, will certainly meet with the charge that such proposals are unfair and undemocratic. Yet, Congress must balance the long-term interests of the overall economy against the immediate interests of the shareholders of the moment. Do shareholders have the right to squeeze excess profit out of a company every time the company's stock price dips below its asset value? If they have this right, does it outweigh the rights of the employees, community, suppliers, and other who are dependent upon the continuation of this economic enterprise?

I recognize that Congress is wary of removing any of the existing incentives for corporate managers to be more efficient. But takeovers do not, in actuality, serve this purpose. Long before the current craze of takeover speculation, there was in place an institutional system of checks and balances on management. The first, and perhaps most important check, is the market for the company's product or services. This barometer will accurately alert the board of directors if current management is complacent or inept. And no board of directors wants the corporation to go downhill on its "watch." Also, directors are particularly sensitive in today's litigious atmosphere to their potential liability for failing to meet their fiduciary responsiblities to shareholders.

Also, as a further check on management, there are the company's commercial and investment bankers, the rating services, the financial journalists, and, ultimately, the ability of shareholders to sell their stock. As a management discipline, none of these, of course, entail the massive disruptions and distortions that characterize the alleged discipline of hostile takeovers.

The current situation cries out for a legislative solution. Neither the courts nor our state legislatures have been able to successfully deal with the problem. Given our trade deficit and the concerns about the future economic health of our nation, for Congress to allow the takeover game to continue unchecked, would be economic suicide.

The **Chairman**. Thank you very much, Mr. Sigler.

PUTTING COMPANIES INTO PLAY

Mr. Slocum, there is a growing concern that investment bankers, together with the raiders and risk arbitrageurs have been putting companies into play in order to reap the astronomical fees and profits involved without any regard for the future consequences of these transactions. In short, there has been a considerable market manipulation involving takeover stocks.

Is that your impression, and if so, how is the company put into play and the company stock and future manipulated?

Mr. **Slocum**. Well, Transco has not had first-hand experience in that, fortunately, I might add, although being ground through the rumor mill, we have seen our stock run up, and it certainly raises eyebrows if not serious questions of concern as to what has triggered that. Is there a leak of inside information? We haven't seen any of that, but typically, what it is, is an arbitrageur feeding on an investment research report or something else that is opportune at the moment. The word travels very fast, and the next thing you know, a thinly traded stock like ours can move as much as 10 percent in 2 days, which obviously sends everybody to their battle stations to find out what is going on.

I guess the answer is, everybody has an opportunity to make a dollar as long as they do it on the basis of commonly held information or original research to get any inside advantage they might perceive is there. I don't have any qualms with investment bankers playing the game, as long as they don't do it on the basis of inside information on Transco and manipulate us, based on it.

The **Chairman**. I know in some cases, of course, there is a battle in unfriendly takeover, the corporation wants to defend itself and the way it does it is to borrow money and buy up stock, trade equity for debt; is that right?

Mr. **Slocum**. Well, that can be one alternative. To sell assets or try and figure out what is on the potential investor takeover group game plan, and if it is a better one than you have, maybe you ought to adopt it.

The **Chairman**. But at any rate, in the long pull, the corporation is loaded down with debt and, therefore, is handicapped with what it can do with its income. It is limited. It can't put its income into R&D or making itself more competitive.

Mr. **Slocum**. As I pointed out in my testimony, the energy industry usually is victimized by seeing its highly risk capital oriented drilling budget be the first one to get the axe. At a time when we are not even replacing our reserves in this country, it seems to me that is detrimental for not only a company but also an entire industry.

The **Chairman**. Mr. Sigler, I would like to ask you about the margin requirements. It is my understanding that in a junk bond financed hostile takeover, a single person can acquire a multibillion dollar company using the company's own assets to finance the takeover. It has also been said that one corporate raider, Ronald Perlman, to quote Fortune magazine, "has used Drexel financing to build a $2.6 billion corporate empire without having invested a penny of his own."

Now why aren't margin requirements enforced? If most of us buy a stock, we can borrow half the cost of that stock from a bank, period. Margin requirements are enforced. I called the Federal Reserve and asked to speak to their expert on it. He said, well, in order to make this enforced, you have to have a right of action. In other words, the corporation has to have the right to go into court and sue and insist that the takeover people use at least their own money, to the extent that the margin requirements would demand.

Do you think that that would have a practical effect here and a constructive effect, if we provided that private right of action?

Mr. SIGLER. Well, I think that is the major issue, Senator. No matter what is the end result of an end play, whether it is a takeover, whether it is a leveraged buyback, or a leveraged buyout—the amount of debt acquired is what controls the options of the company.

Whether the Federal Reserve margin requirement would do it was never tested.

I think the thing that bothers many of us is mandating the debt requirements or the debt that a company can have, because if you will just look at the people you are going to talk to today, the companies are all different, and should be dealt with differently. I guess the issue is, what can be the control on the people who are putting the debt in. I think the thing that you've got to keep in perspective is that the risk level for the people who are buying the debt is very small. We are talking about very large commingled fixed income funds that can throw $25 or $50 million in, and if it works out, fine. But if it loses, it is averaged out over a couple billion dollars. These are ERISA-mandated funds, and I think some approach of attacking the person who is buying that subordinated debt is probably a healthy one. A very tough issue to deal with.

The CHAIRMAN. Thank you, sir. My time is up. Senator Armstrong.

Senator ARMSTRONG. Thank you, Mr. Chairman Just for openers, could we ask each of the witnesses to tell us what proportion of the company shares they own personally? They are each of them chief executive officers of their company, and what percentage of each of their companies their directors own as a group.

Mr. Roderick, would you start?

CEO SHARES OF THEIR CORPORATIONS

Mr. RODERICK. I will be happy to, Senator Armstrong. I personally own about 30,000 shares of USX. That is probably about one-hundredth of 1 percent. We have——

Senator ARMSTRONG. One-hundredth of 1 percent?

Mr. RODERICK. That would probably be about right. We have 259 million shares.

Senator ARMSTRONG. What about other directors of the company and officers as a group?

Mr. RODERICK. I think the largest holding by an individual director would come to about one-tenth in our particular case of 1 percent, which is a very substantial holding. Keep in mind we are dealing with——

Senator ARMSTRONG. I understand that represents a lot of money.

Mr. RODERICK [continuing]. A market of $7.5 or $8 billion. So obviously, no individual, unless he is the wealthiest man in America is going to have a very high percentage of USX, Mr. Armstrong.

Senator ARMSTRONG. Mr. Plank, the same picture in your company, more or less?

Mr. PLANK. Well, I was the founder of Apache Corp. 32 years ago. We didn't have any promoter stock, and at the present time, our proxy material shows a direct ownership of about 150,000 shares and options——

Senator ARMSTRONG. I am really concerned about the percentages.

Mr. PLANK. Three-fourths of 1 percent directly owned, with a call on another one-fourth of 1 percent.

Senator ARMSTRONG. How about the officers and directors as a group?

Mr. PLANK. In aggregate, they would own 7 or 8 percent.

Senator ARMSTRONG. Mr. Murray.

Mr. MURRAY. In our company, we have about 12 million shares outstanding and the officers and directors own about 15 to 17 percent of the company.

Senator ARMSTRONG. Mr. Slocum?

Mr. SLOCUM. I guess I own about one-tenth of 1 percent with some additional shares potentially available under option. Our officers and directors in total probably have ownership of approximately 5 percent. Our employees, if you are interested, have about 15 percent.

Senator ARMSTRONG. Mr. Sigler.

Mr. SIGLER. Our percentage would be about the same as any large publicly owned company, very miniscule.

Senator ARMSTRONG. Less than 1 percent?

Mr. SIGLER. Oh, certainly. If I might add, when I have been asked this question, I think it is interesting to turn it around and ask what percentage of my net worth is tied up with Champion, and there it is very, very large, and it would be for my officers too, but the total value of the company is at a point where an individual who works in that kind of a company basically acquires an ownership through options over a long period of time. It is very slow.

Senator ARMSTRONG. Mr. Sigler, you made the point that you think there ought to be some requirement that debt which is used in a takeover be controlled in some way, either the amount be limited or that those who are engaged in a tender offer be required to finance their takeover in some way, that is, not through debt or only through certain kinds of debt.

Did I understand that point correctly?

Mr. SIGLER. No, I think what I would say on debt is, in all of the suggestions on it, I haven't seen one that solves the problem very well, because imposing debt restrictions on an individual company is very difficult. I think as far as debt is concerned, I would look very seriously at the suggestion one of my colleagues made that when someone is going to acquire a company, their financing should be in place. That I think is very critical to the game. My comment on the institutions was to show where the money came from and how it was financed. I do think there is something peculiar about the fixed income side lending money to buy the stock from the equity side of a fund for a very large profit. I think that is a problem.

Senator ARMSTRONG. Do you apply the same standards in an LBO?

Mr. SIGLER. Yes.

Senator ARMSTRONG. Mr. Slocum, you made the point that there's been a lot of capital drained out of the energy business from the drilling operations. Could you give us kind of a comparative evaluation? We know that the number of drilling rigs in operation has dropped by approximately—well, to about 10 percent of what it was a few years ago.

How much of that precipitous drop is caused by takeovers and how much of it is caused by the decline of oil prices?

Mr. SLOCUM. Well, as you can imagine, it is tough to develop a response with pinpoint accuracy, but——

Senator ARMSTRONG. Mostly a price response or mostly a takeover?

Mr. SLOCUM. I would say mostly a price response, since that's——

Senator ARMSTRONG. Almost entirely? Could we confidently expect that if the market thought oil prices were going to go back up to $40 or $50 a barrel, that we would have drilling rigs on every street corner, drilling for oil?

Mr. SLOCUM. You know, the higher the price, the more incentive there is.

Senator ARMSTRONG. I don't mean to be argumentative, but the impression that I got from your statement was that the effect of all of this takeover activity was that we weren't going to be energy self-sufficient.

My time, I note, has expired. I would be glad to pursue it with you when we can.

Mr. SLOCUM. I think the facts speak for themselves that certainly the preemption of risk capital going into drilling has taken place, and I would—can I cite you some figures?

Senator ARMSTRONG. With the Chairman's indulgence. I've been told my time is up. But I don't think that's what the facts show at all. I think the facts show, when the prices went down, people quit drilling. And they start again when the prices goes back up.

Mr. SLOCUM. If I could have an extra minute, I would like to give you some facts, if I could.

Senator ARMSTRONG. Go right ahead.

Mr. SLOCUM. In my prepared testimony, there are several statements in a paragraph, the long and the short of it is, this country spent $32 billion in 1985. And if you look at just several of the major transactions, Chevron-Gulf, Mobil-Superior, Texaco-Getty, after the fact, in 1986, they spent on the order of $4 to $5 billion less than they did in the prior year, and there is no question that a significant amount of that was due to the need to preempt their cash flow in favor of debt service, as opposed to high-risk drilling.

Obviously, 1986 was not a good year for pricing, so that, you know, added to their decisions. How much, you'll have to ask them.

Senator **Armstrong**. Thank you, Mr. Chairman.

The **Chairman**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman. I want to thank the panel for what I think has been excellent testimony and obviously, very carefully prepared.

I would like to ask each of you to give a response to this question, and that is, I gather from what you have said that you have some real sense of urgency about these problems, that they've gone on long enough as you see that the abuses are now of a scale, taken together, that your level of concern is such that corrective steps, many of which you have recommended, have to be taken.

LEGISLATION NEEDED ON ABUSES

So my question is, am I hearing you correctly? Are you, in effect, saying that this is a big urgent problem, and that it needs to be dealt with, and that you are asking us to take legislative steps to implement recommendations along the lines that you have generally put forward here today. Are you saying, that it is that kind of a serious problem and the time for the Congress to act is now? I would like as close as you can get to either a yes or a no on that. And I would like to go right down the table.

Mr. **Roderick**. Senator, I would say my answer is "Yes," but I think it breaks down into two problems. I think you have what I call obvious abuses by speculators. They are so obvious that you can drive a Mack truck through the loopholes. I think they ought to be acted on immediately, because they are apparent to everybody. They are abuses, and everybody recognizes the abuses. They don't need a lot of study. They just need to be closed. They are just loopholes for abuse, and they should be corrected, and they should be corrected immediately.

Now you get into much longer term questions, I think, when you start getting into who can hold what percentage of junk bonds and many other things, where you don't know what the total implications of some of those changes would be, and I think that they require a lot more study and a slower course of action.

So I think you have a twofold problem. One, an immediate one that should be corrected immediately, and then an ongoing study to see, from a structural point of view, if we need further regulation or further change or simplificaiton down the line, Senator.

Senator **Riegle**. Mr. Plank, do we need to act now, in your judgment?

Mr. **Plank**. In my judgment, we should see action immediately. Last year, for example, we understand that the total amount of money involved in mergers, acquisitions and LDOZ's, which is very frequently able to be characterized as a raid by insiders on a long-term shareholder interest, the money in aggregate employed by these was about $170 billion. The total amount of money invested in productive plant and equipment last year was somewhere around $140 billion. Now all of that is right out of American competitiveness. You had mergers and acquisitions alone, a substitution of about $60 to $70 billion of debt for equity. There is absolutely no question in the oil and gas industry that the servicing of that debt, the cost of the interest against that comes right out of the drilling budgets of Phillips Petroleum and other companies who have gone through that kind of situation. The situation is worsening. It is not improving, and particularly, when coupled against the devastating trade imbalances that we are running, where someone has pointed out, if you run $175 billion trade imbalance last year that is the equivalent of 4 million American jobs.

If we want a healthy country, then I think we have to do something and do it now.

Senator RIEGLE. I appreciate that, and just given the time pressures and the others that are coming, I want to tighten this down even more. It is not often that we have major business leaders come to the Congress and ask for legislation. That is unusual. [Laughter.]

You are here—you are here at invitation, but you have elected to come. I hear a great sense of urgency in what you say. I have listened to every word that has been said, and it seems to me you are asking for a legislative response. You have been very specific about where you think it ought to be, and you've broken it down between short term and long term, and so forth, but that by itself is a very significant fact, and I want to be sure I am hearing you right. That this problem is now big enough. It's gone on long enough. It's serious enough. It's not self-correcting, and that you feel that there need be some legislative steps taken to deal with it. That is what I am hearing you say, and I just want to make sure I am hearing you properly.

I want to give the rest a chance. Mr. Murray, am I hearing you correctly or not?

Mr. MURRAY. My answer to your question is, "Yes," it is an urgent problem. Ours is a modest-sized company. I am hearing my executive, we spend an above average amount on research as far as food companies go. I am hearing these individuals say, what will happen if we keep this up? We are investing in tomorrow's biotechnology. If we cut any of those kind of things, we obviously are going to have less of a future. We just can't allow this kind of madness to intrude on good long-term managerial thinking.

Senator RIEGLE. Is that your view, Mr. Slocum? It's time to take some legislative action here?

Mr. SLOCUM. Absolutely, yes; we haven't talked about structural defenses, but our company, as I am sure all of these companies do, too, have structural defenses, super majority rules, staggered board and the like. The major purpose of that is to have a more rational process to be put in place. More time, more opportunity to get fair value for our shareholders, in the absence of corrective legislation, and that is why we have put those defenses in place.

Senator RIEGLE. Mr. Sigler, do you feel that way too?

Mr. SIGLER. Yes; but I would like to add that it is not new legislation we are talking about. Everything that we are talking about is already governed by Federal law and regulations. There is no free market in anything we are talking about. All the actions that we are dealing with, the tender offer or whatever, are run today by government regulation. And I would say those regulations have to be adjusted to get rid of the kind of things that we have been talking about, yes.

Senator RIEGLE. My time is up. Thank you.

The CHAIRMAN. Thank you, Senator Riegle. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you. There is one thing I want to be clear on. Many of you have made a lot of very interesting suggestions, but unless I misheard, I don't think any of you have specifically proposed either banning junk bonds or restricting the purchase of junk bonds by what we call insured institutions. Am I right? That is very interesting because, as you know, there has been a lot of talk regarding that as the first target. Since everybody agrees and everyone is, in a sense, on the firing line when the junk bond shells land, I think we can go on to some other subjects.

CREEPING TAKEOVERS

Mr. Slocum, as I understand your testimony you say, that once somebody acquires 5 percent of a company, if they want to buy one more share, they then have to make a fully financed tender offer. You are against creeping takeovers. Now that seems to me, to be devil's advocate, to be ridiculous.

If somebody wants to hold shares for investment purposes above 5 percent, at that point, you say, sorry, it's all or 5 percent.

What is the logic of that position?

Mr. SLOCUM. The logic is that existing shareholders should have the benefit of knowing the intentions of his investment. If it is for control, and we are too, in effect concerned about existing shareholders having equal benefit of that information we ought to be informed, so shareholders can evaluate their holdings accordingly.

Senator HEINZ. Maybe I misunderstood your statement. As I read your statement, and I read it carefully, I didn't see any reference to any qualification of that.

Mr. SLOCUM. Well, typically, if an investor group takes in excess of 5 percent, they have to reveal that they have that position, and in a disclosure statement related to the transaction, reveal what their intentions are for that investment.

Senator HEINZ. So you would say, if they say it is for investment purposes only, you wouldn't require a tender offer.

Mr. SLOCUM. Right.

Senator HEINZ. Then I misunderstood your statement. I apologize to you.

Mr. SLOCUM. OK.

Senator HEINZ. What you then would say is, there has to be much more careful policing of content of those statements.

Mr. SLOCUM. Yes, and I think they should be presented, filed, in a timely manner. Right now, it's in 10 days; you know, the Pony Express went out a long time ago.

Senator HEINZ. Mr. Plank over here proposed a rather interesting concept. He basically advocated an impact statement, that in his words, would evaluate what the proposed takeover by a so-called raider would do to all the constituents of the affected company. I assume that "constituents" constitutes not only employees and debt holders but the community as well. Obviously, anybody who has been on the receiving end would have some sympathy for that. But again, to be devil's advocate, is that going to be another environmental impact statement where the paperwork just piles up, or would you feel comfortable endorsing Mr. Plank's idea?

Mr. SLOCUM. Well, it is the first I have heard that concept. Typically, an acquiring group will reveal, if it is total control that is in their plans, what they are going to do once they get control to enhance the value, particularly if it is something other than an all-cash deal and securities are involved. You have to have some plans to properly evaluate and give a fairness opinion on those securities.

To some degree, I would support him. For the totality of it and how extensive, maybe you'd better ask Ray.

Senator HEINZ. Dave Roderick, you are my constitutent and you have been through a war. How do you feel about Mr. Plank's suggestion?

Mr. RODERICK. Well, again, I think it is one that I have heard for the first time. I would want to examine that in more depth. Again, Senator, I think it is important that we need corrective action on the serious abuses—the early creep, the financing out options that the raiders use and the speculators use. And those type things I think can move very, very rapidly. I think when we start getting into impact statements or longer term implications of debt structure and requirements, then I think those things have to be examined very, very carefully to make sure that they are serving us all well. And I would want to examine that idea more fully, and at this point, I would not want to say I am either for or against it.

GREENMAIL

Senator HEINZ. Let me turn to the subject of greenmail which you mentioned in your statement at some length. You said that not only should greenmail be prohibited, but companies should be prohibited from picking up the investment banking fees and legal fees that the greenmailer engages in. You have just been through kind of a takeover attempt. Did you, in your dealings, ever consider payment of greenmail?

Mr. RODERICK. No. We said right up front, we would not pay the fees of a raider, either legal fees or investment banking fees. And I think they should be clearly outlawed. I think that abuse has just been so apparent and so enriching to raiders and those associated with them, and it is a real ripoff of the shareholders. I think it borders on the criminal.

Senator HEINZ. Mr. Chairman, my time has expired. I was just getting going too.

The CHAIRMAN. Thank you. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman. A lot of the corporate raiders in the country, so-called, often alleged that their takeovers are basically intended to weed out inefficient management in business. Do you, this group here, think that the raiders look for poorly run companies in choosing their targets, or do they look for something else? Yes, sir, Mr. Sigler.

Mr. SIGLER. The game can't be played on a weak balance sheet. The game is an asset game and the borrowing, the debt has to be based on the ability to maneuver those assets and sell them if you take over. So the process can't work in a very badly managed situation. We really have no good examples of the kind of takeovers that raiders talk about where someone comes in and throws out the poor, entrenched, greedy, self-serving management and manages it well, because the debt financing is such that you have to liquidate or drastically change the company.

I don't think that any of us are going to sit here and defend all managers of all corporations in the economic system.

Senator **Shelby**. Mr. Roderick.

MOTIVATION IS THE QUICK BUCK

Mr. **Roderick**. Well, I don't think that that is really ever the motivation of a raider. I think let's get down to what the motivation is. The motivation is to make a quick buck and make as many of them as he can and try to rationalize to get an emotional issue going that might get him some support. I think that most of the target companies have been very good companies, and of course, the reason that they are good and the reason they can go out and borrow large sums of money against them is that over the years they have tended to be very well-managed and therefore, people are willing to lend money into them. And as Mr. Sigler said, if you had a badly managed company that did not have good assets, did not have a good balance sheet, the total game played by the raider would fail every time.

Senator **Shelby**. Mr. Pickens is always saying he is after companies that are poorly managed, poorly managed, considering their assets, but he has also found the ones with some underlying wealth; has he not?

Mr. **Roderick**. He has been very selective, and I think that if you look at some of the companies that Mr. Pickens who I know has gone after, I think when you start talking about the Phillip's and the Unocal's and the Gulf Oil's of this world, I think anybody that would claim they have been badly managed over the years would really have to be stretching their imagination.

Senator **Shelby**. To the panel. Do any of you or all of you believe what some business leaders have said and asserted that the securities laws as they exist today favor the corporate raider? Mr. Plank?

Mr. **Plank**. Well, I believe that—there was a question earlier on which bears on the same phenomenon. One of the reasons why we needed immediate action on the part of the Congress is that, at least under this administration, the market type of approach has led to entirely different interpretations, and if it comes to, for instance, in the Justice Department, today, virtually all mergers are acceptable without the assumption that they limit competition. Or if it comes to the Securities and Exchange Commission, until quite recently, with the phenomenon of excessive takeover greed having driven it, it's been adequate to say that if you disclose that you are making your initial investment for investment purposes, those have met the criteria of the Securities and Exchange Commission up to this point. But because, given the phenomenon that we are looking at excessiveness here, either—I believe that the regulatory process needs to be fine-tuned in the form of legislation which will deal with it. It is in that context, where an impact statement, I think, is important, that a raider, if he is going to be thinly capitalizing an attack, should indicate that he intends to use the capital assets as an asset strip and to indicate what the effect is going to be and ought to be able to say it all in a page.

Senator SHELBY. One last thing, before my time runs. If we limit, as public policy up here, the use of debt, should we apply these restrictions across-the-board to bank debt and other forms, as well, instead of just focusing in on junk bonds? Mr. Roderick?

Mr. RODERICK. Well, I think that one of the problems that—I don't think there is anything wrong with debt. I think that most corporations have it. I think it only becomes a problem when that debt becomes tremendously excessive, as it would have in the case of USX, had we been acquired this past year, and the only way the corporation could have continued to operate in that environment would have been by substantially reducing our drilling, substantially reducing our capital budgets and reducing our research.

I think when you start getting into the argument of whether you can use what I would call rated bonds or investment grade bonds versus junk bonds for whatever legitimate financing. I think the only thing that we have to be careful of is that we don't try to prop up weak financial organizations by letting them run to all low grade noninvestment grade bonds.

Now this is of a longer term nature. I think it has to be studied very carefully, but if we get into a tight economy of a mild recession, some of the abuses on junk bonds are going to come home to roost and are going to come home to roost very, very quickly. I don't think they should be outlawed. I think they serve a place in our economy. A lot of noninvestment grade bonds are out there that are perfectly legitimate, will be paid off, the money's been borrowed for very legitimate reasons, and I think you have to be very careful of attacking that as a financing mechanism.

I think we are in a leveraged society, and I think we are going to stay there.

Senator SHELBY. Thank you, gentlemen. My time has expired.

The CHAIRMAN. Well, thank you, Senator Shelby.

NOT A ONE-SIDED SHOW

Before I call on Senator D'Amato, I would like to point out, several members have whispered to me that they are concerned about this being a one-sided show, that we are having the people in on one side who, of course, are against takeovers—or at least critical of the way some of the way takeovers are handled, not against takeovers overall. We haven't heard the other side.

Well, the fact is, we have heard the other side. We have had Boone Pickens testify. We've had Goldsmith testify. We've had Fred Joseph with Drexel Burnham. We had Joe Wright, the Assistant Director of OMB, who is also against the legislation in this area, testify. We had a number of investment bankers come in, who said that we should act, but they were investment bankers. They weren't chief executive officers of corporations.

We intend in the future to have them come back again. We want to have a balanced situation.

So I don't want to give anybody the impression that this is a rigged show, and we're just asking people on one side of the issue. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Regarding greenmail, on which I happen to agree with Mr. Roderick, I think it should be restricted. However, for greenmail to succeed both bidders and targets must cooperate. In many cases I think that those who are paying greenmail inflict more injury on a corporation and its shareholders than the raiders.

Mr. RODERICK. I agree.

Senator D'AMATO. And that is just taking the assets of the company and paying them out to keep in power, I think better methods can be employed to protect the interests of a target's shareholders from pure financial plays.

A number of proposals, including S. 227, which I have introduced contain specific legislative provisions which we should begin to address in detail.

What specifically would you recommend by way of legislation? There has been a lot of talk about the 10-day window being closed, and I agree that we close that 10-day window. I propose that an acquirer file immediately after someone has acquired 5 percent of a company's shares.

I would like us to be a little specific though. Greenmail, we agree. 10-day window, we agree. More information with respect to the names of the parties, the identities, what their purpose is. Fine.

What else would you ask for? Any of you.

SOLUTION IS A SERIES OF THINGS

Mr. SIGLER. I think the solution is a series of things, not one great stroke. I believe all of those proposals have merit. I think the critical thing—whether it is any one of the type of suggestions made here—is to put a logical process in place, one that allows time for deliberation and full disclosure on everyone's part and a vote on the long-term good of that action.

That process might include a 13D closed window, a limitation on how much you could buy before you had to go for the whole company and full disclosure of what you intend to do with it, what would the financing be, et cetera. If we merge two companies, we have to put an amazing disclosure out about what the consolidated balance sheet will be and how we will be able to deal with it, so that the shareholders could vote on it. I think if that process were in place with takeovers, then we would be more than willing to get rid of poison pills, greenmail, et cetera. I think everyone agrees that greenmail has to come out. No one can defend it. I think what we have to have is a deliberate look at what is a very violent act in the lives of a lot of people and maybe, more importantly, in the ability of the economic system to maintain strength.

Mr. RODERICK. Senator, I think another thing that should be looked at is, again, I think legitimate offers should be permitted, whether they be hostile or friendly. I think there is nothing wrong institutions and member firms in 1986. Larger corporations also find their institutional ownership higher than average. For example, approximately 70-80 percent of the shares of Champion International Corporation are owned by institutional investors.

Shareholders used to be individuals who put their dollars and faith behind specific institutions. But the individual shareholder with a proprietary interest in the company is no longer typical and the small investor with 100 shares of stock or less hardly exists any longer.

Instead there has been a massive concentration of power in the hands of a relatively small number of institutional investors. Pension funds alone are forecasted to control significantly over one trillion dollars in funds in the near future. The managers of these large pools of money, whether it be pension funds, mutual funds, or other institutional investments, are under intense pressure to make a quick return on their investments. Their performance is reviewed on a quarterly or more frequent basis and job security is often dependent upon "beating the averages." As a result, these fund managers have no loyalty to the long-term future of any particular company in which they invest.

The computerization of investments has exacerbated the situation and made it even more impersonal. Index trading and program trading are perfect examples of the problem. Many investment decisions to buy or sell are based directly on the movement of the various market indexes. Thus, hundreds of thousands of shares are traded every day because a computer has made the decision to do so.

Consider a major U.S. corporation employing tens of thousands of people and providing the vital economic underpinning for numerous communities around the country -- the situation has reached crisis proportion when the decision as to whether to break up that company and sell off its assets piecemeal can be made by computers. Decisions are often no longer based on individual research indicating that a particular company is an attractive long-term investment.

In addition to fund managers with short investment horizons, and computerized trading, there is another element on Wall Street whose greed and need for instant gratification is fueling the takeover speculation. As the widening insider trading scandal reveals, many on Wall Street have ignored the ethical and legal implications of their actions in order to achieve their gains.

But even if Congress were able to stop all such illegalities, it wouldn't change the regulatory framework that allows a change of corporate control to be made by the shareholders of the moment.

When we combine this new institutional shareholder population with factors such as the utilization of junk bond financing and a volatile stock market that generally does not reflect the true value of a corporation's assets, we have created a situation that is ripe for financial speculation. Corporate raiders have recognized that this situation presents them with a relatively risk-free opportunity for financial gain. It is now possible to manipulate the system by purchasing a significant block of stock in a target corporation, waiting until the majority of shares has been aggregated in the hands of a few speculators (because many of the institutional investors will sell out immediately to take advantage of the initial run-up in stock price), and then forcing the target company to either pay greenmail, seek a white knight who will pay a premium for the shares, restructure with increased debt, or turn the company over to the raider for its eventual break-up and sale. Any one of these potential outcomes results in enormous profits for the raider himself and generally smaller profits for the individual shareholders who were invested in the corporation at that point in time.

Under these circumstances, raiders do not, as is often alleged, look for poorly managed companies as their targets. Rather, they seek corporations with strong balance sheets, with overfunded pension plans, with large research and development budgets, with distinct operations that could easily be sold off piecemeal, and with other attributes which would make speculation in that company's stock attractive.

But the one factor which assures the raider success perhaps more than any other is that there are so few shareholders of the target corporation who are loyal to and interested in the long-term future of that enterprise. T. Boone Pickens and his fellow raiders invoke "shareholders' rights" in defense of their actions. But when shareholders are arbitrageurs who hold their stock for a few days or even just a few hours, what should their rights be?

In light of these circumstances, I believe that it is time to reconsider the meaning of the term "shareholders rights." Historically, corporation law borrowed from property law in defining the rights of shareholders. As a result, the notion of shareholders as the owners of our publicly held corporations, in the same way that one is the owner of real estate, is deeply with those. Many times they are in the best interests of the shareholder, and if somebody wants to buy all of a company, be it hostile or friendly, they should be able to proceed. They ought to be able to—what we are trying to get rid of are those people who, in effect, put a company in play that, in effect, are purely speculating and have no intention themselves of actually making the acquisition.

Senator D'AMATO. They are just looking to drive that price up; is that what you are saying, Mr. Roderick?

Mr. RODERICK. Well, the type of thing I am talking about are offers that are made but have a qualification in there or a proposed offer that will be made subject to financing. There is no obligation for that party to follow through. They have to put the company in play. They have driven the value of the stock up from a speculative point of view, but they are under no obligation whatsoever ever to make good or actually make an offer. It is purely, at that point, a one-sided game. I think that investment bankers working with a potential buyer, if they are going to make an offer for a company or allege that they are going to make an offer, they should have to demonstrate to the satisfaction of the SEC or some body that they have the financing in place, that they have the wherewithal to do it.

The other thing that I think that some of these glaring abuses, such as greenmail, the 10-day window, those are things, Senator, that I think that all of us that are interested in financial America, and the ability to finance legitimate transactions, I think the sooner we act on those, the better, because, I think we have to get this, let's say, semihysteria out of the market from the standpoint of some of the scandal that is going there, the lack of confidence that many people in America are beginning to build toward Wall Street and really, these transactions are relatively small. They are abuses. We ought to stop the abuse, so that the marvelous financing mechanisms that we have in place in this country can continue and regain the respect that they need to gain in order to survive and help the corporate process in the United States.

Senator D'AMATO. My time has elapsed, and I would like to thank all of the witnesses, particularly Mr. Roderick. I think he has touched on a very valid point, which is that there are certain definite abuses that we are concerned about and we must seek to remedy them.

I want to compliment you, Mr. Roderick, for what I think is a very balanced view. I think we should move quickly to enact reform where needed. If we get too ambitious we may jeopardize quick passage of any legislation by getting into tangentially related areas such as the high yield bond controversy. That is controversy that takes on various aspects, and I do not believe that it should be part of an attempt to deal with the areas that cry out for immediate reform. I would like to explore with you at some time your ideas about having the financing more tied down.

I am concerned about that, and I would like to explore that issue but I do very much applaud your balanced presentation, and thank all of you for giving me the opportunity of getting your points of view.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator D'Amato.

Senator Sanford.

Senator **Sanford**. Thank you very much and I thank all of these panel members for splendid testimony. I show my bias in the beginning by saying that I applaud almost everything said and can't wait to see it put in legislative form.

Just as a matter of interest, how did this get out of hand? We were going along fairly well and didn't change any rules or regulations or laws and all of a sudden this takeover mania began to sweep the country. Did they just learn about it?

Mr. **Roderick**. Well, I believe, Senator, that again, there's no question that there are a lot of legitimate mergers and acquisitions that have taken place. There's been an acceleration of that. I think many of those are very good for America to improve our competitiveness.

ARB COMMUNITY IN NEW YORK

I think what happened was that people, especially the arb community in New York, the investment banking groups, began to find that there were ways to participate in that process to excite the process without actually making the takeover.

And over a period of time they have experimented and found where those loopholes are and they have developed a game that has been constantly improved upon. And I think that the abuses that have been commented on today are things that weren't well perceived or well understood 10 or 20 years ago, but now people know that that abuse can be successful; it can be very financially rewarding for the raider—not so much for the shareholder—and when one party is successful at it it excites a lot of other people into the game.

And I think the game has gotten perfected in the last 3 to 5 years and naturally it is being played more frequently.

I think again with some of these relatively, I would call them, important changes that could be made quickly I think would bring that back to more sensible levels and get the merger and acquisition back to where legitimate players would be playing rather than the marginal player who is only out for the quick buck, normally at the expense of the shareholder.

GREED, GOOD INTENTIONS, AND LACK OF OVERSIGHT

Mr. **Plank**. I think three phenomena came together concurrently, Senator. Driven by greed, the investment bankers as well as the principal protagonists of this merger game—violent merger game—went out and propagandized America that really they were Robin Hoods and that you had evil self-serving management. That created an umbrella. That's why some of us who are here today who started and participated in Stakeholders in America, wanted to create a countervailing argument against cleaning up corporate America's abuses.

The second phenomenon was that the administration under—with all good intentions, certainly with a free market approach let it be known that their attitude through the Justice Department in terms of restraint of trade operations would not be pursued as it had been before.

There is no way that Chevron would have been able to acquire Gulf under prior administrations. It just couldn't have happened.

The same thing happened in terms of the Securities and Exchange Commission. The responsibilities for disclosure were not looked to beyond the very limited statements "for investment purposes only."

Those three things came together and hundreds of billions of dollars have changed hands in a rapidly and relatively short period of time. It's that convergence that you all need I think and hopefully so diligently are addressing here that may lead to a little tighter legislation in general.

Mr. **Sigler**. The money, Senator, the money. The ERISA money. They are a different breed of shareholders than we've ever had before. These are very, very bright people who put together a game that has paid off in individual wealth more than anything in history. It's institutionally managed money that has made it possible to go after any company in this country.

Senator **Sanford**. Meaning the new kinds of financing?

Mr. **Sigler**. The $2 trillion that's professionally managed, institutionally managed, of essentially retirement funds. The ERISA mandated money is what fuels it. The game was a very small game and it's become a very, very big game.

Senator **Sanford**. Thank you very much. I think my time has expired. I appreciate so much your comments.

The **Chairman**. Thank you very much.

Our next member to question will be Senator Gramm.

Senator **Gramm**. Thank you, Mr. Chairman.

Well, let me first say that I object to the term "junk bond." I think it conjures up in the public's mind something that does not exist. In fact, by my figures there are only 700 corporations in America that have investment grade bonds. There are 30,000 noninvestment grade companies and I tried to look up in my State—we've got only 34 companies in Texas that have investment grade securities. We've got 1,740 that would be issuers of noninvestment grade securities.

And I think when we're talking about junk bonds, we're talking about bonds that are fueling the growth of America.

I am very concerned, deeply concerned, about an effort to limit the ability of people to get capital. We run around talking about American competitiveness and yet we have an assault on the ability of people with new ideas, new products, new ways of producing things, to go into the capital market and compete and I find this very hard to understand when the data I have clearly shows that bank loans have been far more important in mergers and acquisitions than the so-called junk bonds, which is the last time I ever intend to use that term. 73.1 percent of mergers and acquisitions have occurred with the use of bank funds.

Now I'd like to ask each of you very briefly, are you concerned about Congress taking action that will limit the capital access of the new producer, the new product, the new process, the new vision to capital in America, something that I always thought made our system work?

Mr. **Roderick**. Senator, I would start out by saying that I, for one, would agree with you. I think this term junk bonds is an emotional term that has developed. I think there are some marginal bonds being put out in individual situations and I think it's for that reason that I have made very clear in my statements that I think that the whole question of junk bonds and investment grade bonds is a separate question from this takeover problem.

I think we need to look at that very, very carefully for many of the reasons that you have stated. I think that the committee should be looking at correcting the abuses in the process and not trying to get into making a decision as to what can be issued in the security areas for a given reason. I think that's a longer term consideration that maybe the committee needs to look at, but with a great deal of caution because we do have to keep funds available for legitimate corporate purposes in America and many of those funds are not going to be investment grade securities.

LEGITIMATE VERSUS MARGINAL PLAYERS

Senator **Gramm**. Well, if I just may inject here, and it was a point I was going to come back to, but since you used the term again, I guess the problem I have is you talk about legitimate players versus marginal players, legitimate use versus nonlegitimate use. I don't know how you tell the difference.

Mr. **Roderick**. Well, some of them——

Senator **Gramm**. And I'm not sure that I want anybody other than the marketplace making that decision. I'm not sure that there's anybody wise enough to know what is a legitimate use of capital and what is not, what is a legitimate offer and what is not.

Mr. **Roderick**. I think the word legitimate or marginal application of funds are those that very clearly, as we say, are used solely for takeovers that have increased beyond any reasonable doubt the debt-equity ratios of companies that clearly I think has been spelled out in a number of institutions that have so burdened themselves with debt that part of those securities are somewhat doubtful, but in any event, if they are paid and honored—those debts are paid and honored, they are going to be paid and honored by, in effect, a reduction in research, a reduction of capital spending, and a reduction of drilling in the case of the energy sector.

I think that very clearly, Senator, there have been abuses. I think that anybody that's reading the paper is certainly aware of some of those abuses and I think some of the legitimate purposes of capital need to be preserved very very much so, but I think some of the abuses that clearly have taken place on Wall Street, sort of highlighted by the Boesky affair——

Senator **Gramm**. If I may stop you here since I'm running out of time, none of you are trying to commingle the whole issue of corporate takeovers with insider trading? You're not saying that those things are in any way related?

Mr. **Sigler**. Of course, they are.

Mr. **Roderick**. They might be, Senator, yes. Some of them may be, yes.

Senator **Gramm**. Well, let me just conclude—since I've run out of time on that, and I wish I had heard the others by saying that I am deeply concerned that you are assaulting here, with the best of intentions, the one institution in America that works well, and that's the capital market. I think it's very tempting for all of us to think that we are indispensable to the job that is being done—all of us have concern about hostile takeovers of our seats in the Senate, knowing that the Republic couldn't function without us.

I submit, Mr. Chairman, in concluding, that what we are in danger of here is assaulting the capital market and destroying our ability to grow and to prosper and with the best of intentions and I'm sure with very real limitations it probably will not be part of any legislation that will result from all this, that your company may be benefited, you may be benefited, but I have grave questions as to whether America will be benefited or whether the working people of this country are going to be benefited.

The **Chairman**. Thank you, Senator Gramm.

Senator Graham.

Senator **Graham**. I think you could make the case that America has never had a more sophisticated investment community than it has today. A very high percentage of the capital funds are in the hands of professional management, the concentration of capital in pension plans and other highly professionally directed investors.

In that context, why is the investment community so susceptible to these tactics that you've described which would appear to be of no long-term economic value to the company but rather to the contrary? That is, if a sophisticated investor sees a manipulative set of activities taking place which will result in shredding the company's research capabilities, its ability to invest in greater productivity, why has that had the opposite than expected effect of driving up the value of that company's stock?

Mr. **Sigler**. Well, I think you have to fall back, Senator, on who are our shareholders? Our shareholders are institutions who are very concerned with the short-term profit. They tend to sell into an ongoing market and therefore the concern of the long term of the company is certainly not in their mind.

We do not have a significant ownership situation that sits back and makes a judgment as to what this company will be 3 or 4 months from now because they won't be shareholders 3 or 4 months from now. At least from the perspective of our kind of company, there is no ownership interest responsibly making those judgments. It's simply making the dollar for the investor.

Senator **Graham**. Do other members of the panel wish to comment on that question? I'm particularly interested because my second question is going to relate to the issue of the length of the horizon within which these decisions are made.

Mr. **Slocum**. I'll try and be brief. You've hit on a question of what's the strategic best plan for a corporate management being in a given industry at a given time, and typically there are three. One, the breakup value, sell out. The other is the capitalization structure, how much risk reward you want to put into that. And third is the more conventional investment of cash flow internally for the longer pull.

And if an investment banker or any other outside investor group has a different and, in their view a better, plan, let them present it or take over the company and try and put it into effect. I think the market will prevail and the outcome, if the management is not going to do it the right way, will take it there.

All we are talking about is give us a fair chance to reflect on that plan and if we would agree with it, we'll sell on it. If not, let's go the way the shareholders want to and communicate the reasons for our plan.

Senator **Graham**. My concern is that some sophisticated people, based on the information which is available to them, are making a judgment that this company's stock is worth more after the activities of the raiding party have surfaced on the horizon than it was prior to that time.

I tend to agree with the observation that it is an issue of the timeframe within which business decisions are made and I'd like to ask my final question.

Is there anything in the Government regulatory, tax, or other environment that we influence which has caused that shortened time horizon, or is it inherent in our current capitalist system? And if it is an environment that we influence, and assuming that you would think it would be desirable to lengthen the horizon, what could we do to accomplish that objective?

AFTER TAX PROFIT OF $80 MILLION

Mr. **Plank**. On taxes, I'd just like to deal with one element of it. When Mr. Pickens hit Unocal, he incurred an economic loss. But by virtue of tax inequities, he was able to turn that into an after-tax profit of $80 million.

I would say that that was an incentive under the tax code. As interest has been used in financing what would normally be equity ratios, you've had the deductibility of the junk bond interest as opposed to under normal capitalization rates you would have had a higher measure of equity because there again taxes have tended to be slanted in favor of weakening America.

Mr. **Roderick**. I think, Senator, the only thing that I would recommend—I think that I won't blame the legislative process historically for this timeframe problem. I think that these type of aggressive moves by speculators—and again, I want to keep singling that out from a legitimate purchaser of all the assets of a company or all the shares of a company, which I don't think we should involve ourselves with—but I do believe that what you need today in order to respond in the best interest of the shareholder when you get a hostile or unfriendly offer or get put in play by a speculator on a tender offer, I think that in order to give the management time to maximize the return to the shareholder and give them time to look at the various things that they may do short term to at least offer something better than the raider or the speculator is proposing, that I think today in complex organizations that 20 days is not enough to bring those into play.

And I think that one thing that has been suggested is that that period for a tender offer being open of 20 days is too short today and that perhaps consideration should be given to lengthening that. I would support that provided the lengthening is reasonable. I don't think you need forever, but I think certainly doubling the time to say 40 working days would be in the best interest of the shareholders.

Senator GRAHAM. Thank you.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No questions.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Gentlemen, you are coming before this committee detailing reasons why we ought to be helpful by way of legislation. Frankly, I think you make a good case.

But my question to you is, have you gone to the administration and sought their help in this matter? Have you gone to the Securities and Exchange Commission and sought their help? And if not, why not?

Mr. SIGLER. I think I probably can answer that, Senator.

The administration's position until now has been a very strong free market position, and the Securities and Exchange Commission has supported that free market approach from the perspective of the shareholder.

Of course, our response is that the market has been manipulated, that it is a serious problem, and that the shareholder is no longer the same type of animal.

Yes, we have dealt with the administration for a considerable period of time and their positions are that. Free market I think oversimplifies, but I think that categorizes it.

Senator SASSER. All right. Mr. Roderick, in your earlier testimony you indicated that there were clear abuses in your view that ought to be dealt with.

Would you outline those abuses for the committee which in your view ought to be dealt with and I might ask, when you conclude, if the other members of the panel would wish to comment on that question also.

CLEAR ABUSES

Mr. RODERICK. Well, I think first, the 13(d) period for filing the 5 percent 10 days allows too much of a creep for the raider. It's too large of a window, too long of a window, and I think that ought to be lowered to something like maybe 1 or 2 percent and there's nothing wrong with filing within 24 hours.

I would also suggest that people that allege they want to make a tender offer should have to demonstrate to some reasonable satisfaction that they in effect have the resources to execute on that alleged offer or that offer, if it be an offer, that they shouldn't be permitted to make these offers with all sorts of conditions with the full knowledge that in all likelihood they are never going to go ahead.

I think that very clearly that those are two of the more glaring ones and the other one I would think, from both points of view—

not just management but also from the person who will accept greenmail—that greenmail just absolutely should be outlawed. The payment of the fees to the investment banker and to the lawyers of the raiders should be outlawed. I think it is criminal that we use shareholder funds to in effect pay a speculator for in effect abusing the process.

And I think those are things that could be changed very short term. They are easily legislated and then I would like to see some of these other questions—and I totally agree with Mr. Gramm and if I have said anything, Senator, that implies that I want to disrupt the financing in corporate America, I can assure you that I do not because I am one of the ones that use it extensively and we want to keep those markets healthy. It's absolutely essential that we keep them healthy.

And I think by these type reforms, we can contribute to that health and not diminish it.

Senator SASSER. Gentlemen, do any of you wish to amplify on Mr. Roderick's response?

Mr. MURRAY. Not on that point, Senator, but I do wish to answer your question with another point of an abuse and that is, in many corporations taken over with unfriendly tender offers there's a substantial amount or a meaningful amount of existing debt with covenants and contracts written prior to this current level of madness. They find themselves with equity stripped out and debt replaced. They never would have lent the money to those corporations long term on those terms if they had known the company was going to have a capital structure like that which evolves after an unfriendly tender offer.

In those kind of circumstances, I think ethics requires that those debt holders have the right to put their debt to the company and be paid off. I just think it's unethical to leave them hanging out there and putting them in a comparable position as the buyers of low-investment quality bonds.

Mr. PLANK. I think it would be interesting to consider at least who should have the option of offering the junk bond. If you use it as one of the steps in financing as these things have taken place up to the present time—Milken, for instance, of Drexel-Burnham received the year before last a reputed $35 million and most of it came as a result of proposing before the taking over or the attacking company made the hit—most of it came as a result of suggesting that in the event the takeover was successful, they would in fact then lever somebody else's assets.

I think you ought to maybe consider looking at who really should have the right to mortgage the company's future. Somebody who's going to perform an asset strip, for example, or the duly constituted governance under the then existing method of managing the company?

Senator SASSER. Gentlemen, thank you. My time has expired.

The CHAIRMAN. Thank you very much. I guess all members have had a chance to question. We have two other panels. Thank you, gentlemen, for superlative testimony. Whether you agree with it or not, I think it's very effective.

Senator HEINZ. Could I ask one last question before they go?

The CHAIRMAN. Will you hold it just one minute? Senator Heinz has one question he would like to ask.

Senator HEINZ. I have one question for Dave Roderick who made a number of suggestions on requiring that financing be more certain and that certain kind of takeovers be financed by cash and so forth.

Is there any danger that the end result of your proposal is that only very big corporations can acquire very big corporations?

Mr. RODERICK. No, I don't think so, Senator. For example, a recent experience I have had, the investment banker often supporting one of these potential acquirers will give what he calls a highly confident letter. He is in effect saying that I can get that financing for you. The only thing I'm saying is that the process should be reversed. Rather than merely getting a letter for that acquirer, he should in effect go around and line up the financing so that when they make the offer they have the financing line up, rather than merely alleged that they can do it.

And, no, I don't think that would hold at all and I think that if it were creditworthy, if it had adequate assets, I think anyone, big or small, could go out and get the financing if the company was not already overly leveraged. So I think it would not impede the process but it would in effect restrict the process to those who really intended to acquire and eliminate those who pretend to acquire.

Senator HEINZ. I won't ask a second question but people might want to think about an observation I'll make, which is, if the financing has to be shopped and lined up and commitments made, it may open the people who do that up to insider trading charge perhaps.

Mr. RODERICK. I think that when they issue these highly confident letters, at least from what I've heard and read in the case of at least one financial institution, that is already broadly known within that institution and I see nothing wrong if somebody is going to do that to in effect exposing the fact that they are trying to line up financing to take over the XYZ company which they may be able to line up or may not.

I think in fairness to the existing shareholders that would be probably a very desirable thing rather than an undesirable thing, Senator.

Senator HEINZ. Thank you.

The CHAIRMAN. Thank you very much, gentlemen. You have been a fine panel. We have 11 more witnesses and it's 11:15, so we are going to have to move fast.

Our next panel is James Baker, chairman and CEO of Arvin Industries, Columbus, IN; Donald Clark, chairman and CEO of Household International of Prospect Heights, IL; Dr. William Frist, chairman and CEO of Hospital Corporation of America, Nashville, TN; William Howell, chairman and CEO of J. C. Penney Co., New York; and William L. McKinley, chairman and CEO of the Gerber Products Co. of Fremont, MI.

I'm going to recognize the Senator from Tennesse who has an introduction to make.

Senator SASSER. Well, thank you very much, Mr. Chairman.

I want to welcome to the committee this morning a very distinguished Tennessean and a long-time friend of mine, Dr. Tommy

Frist. Dr. Frist is the chairman of the board of Hospital Corp. of America, one of the most innovative and enterprising health care companies in this country, Mr. Chairman. I have had the opportunity to peruse Dr. Frist's testimony in advance and I want to commend it to the committee, especially that portion of it that relates to the community impact of corporate takeovers.

And I think, Mr. Chairman, the committee will find his testimony most interesting.

The CHAIRMAN. Thank you, Senator Sasser.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman. I'll be very brief.

Mr. McKinley, I particularly want to welcome you to the panel representing the Gerber Co., which is a fine company based in Michigan, and I will be very interested in your comments and the others as well.

The CHAIRMAN. Very good.

Mr. Baker, go right ahead. We have a 5-minute rule, as you know, and we would appreciate any abbreviation you can make for us.

STATEMENT OF JAMES K. BAKER, CHAIRMAN AND CEO, ARVIN INDUSTRIES, INC., COLUMBUS, IN

Mr. BAKER. Thank you, Mr. Chairman.

Arvin is a $1½ billion company making auto parts in 15 States of the United States, 12 foreign countries, with 18,000 employees. Arvin fought off a hostile takeover bid in 1986 and as a director of four other companies I have witnessed six additional hostile skirmishes, one of which was successful.

As the previous panel spent time on, one of the major problems with successful hostile takeovers is that they take the front end out of a business, and I won't dwell on that or elaborate on it, but let me say that as a matter of public policy we must not rob American industry of its cash resources if they are to become and remain world class competitors.

I would ask the question, are friendly leveraged buyouts, [LBO's], and management buyouts, [MBO's], any better? My answer is, no, for they too rob the most precious resource needed for the future health of the company and that is cash.

In our own skirmish, we chose not to use an MBO as a defensive weapon for this very reason. We were not willing to rob our own company of its future cash by committing it to debt repayment.

I feel that if we stop hostile takeovers we will stop LBO's and MBO's because they are most often done in fear of the hostile takeover and if we stop hostile takeovers there may be another significant benefit.

FEES FOR TAKEOVERS ARE OUTLANDISH

Many of our brightest young minds will no longer want to be investment bankers. Our business schools are full of people who want to go to Wall Street and start out with salaries of $100,000 and make $1 million in 6 to 8 years. And this is not idle talk. This is the reports that they give back to the students in business schools that are thinking of their future career.

Wall Street's fees for takeovers are outlandish. Our company was charged over $1 million for a 60-day skirmish.

Raiders know nothing of the strengths and weaknesses of a company. Their approach with us was to threaten me two to three times a day, including a threat to go public with a tender offer on Christmas Eve. That was no idle threat, for they had done exactly that and done it successfully on the previous Christmas Eve.

Why Christmas Eve? They know there are times when the flow of market information is inefficient and when it's difficult to make contacts with white knights, bankers, board members, and so on.

Raiders have little respect for the SEC. They plan their surprise attack to take maximum advantage of regulations and take maximum advantage of those periods when the flow of market information is far from perfect.

They try to use the market. They are not responsible participants in it. None of the seven hostile actions in which I have been involved have been driven by anything but greed—personal greed. And I think you see signs of that when you see what happens with excess pension funds. They go after those for the same reason—personal greed.

Let me say a few words about management entrenchment. There is no such thing. All people resist losing their jobs. Psychiatrists point out that loss of job is very high on the scale of emotional catastrophes. Management does fear the loss of their jobs and the loss of jobs throughout their company.

As we concluded our collective bargaining agreement last year, a UAW union leader extended his hand across the table and said:

> This is a good agreement. We think management is doing a good job. We hope no one takes over this company because we fear the loss of our jobs.

Let me point out that in a hostile takeover all jobs are at stake. Dedication, length of service, experience—they mean nothing. Employees and communities pay the price. Factory workers, clerks, engineers pay the price, not just entrenched management.

Why are hostile raids possible? Not because of inept management. In our own case, Arvin was ranked in the top 10 percent of the Fortune 500 companies in performance. Forbes Magazine ranked us first in our industry. We had split our stock and increased our cash dividends four times in 5 years. Earnings were growing at 37 percent a year. No, we were not inept.

A company becomes a target because of the complex interaction of tax laws, interest rates, inflation, and imperfect market communications that cause a company's future cash flow to be undervalued.

In our own case, we manufacture pollution control devices for cars and trucks and for 15 years we have poured tons of cash into the development of the catalytic converter before finally perfecting it in 1973. I'm sure that our stock price was depressed during those 15 years and I think the question that we ask of American industry today is, should they embark on long, expensive cash-draining R&D projects with potentially great benefits to society in view of the possibility of a hostile takeover?

In conclusion, if the corporation is in existence simply as a financial producing machine to satisfy its owners, then perhaps hostile takeovers are a valid part of that game. But if the corporate purpose in America is to produce worthwhile products and services, to provide adequate returns for risk capital, to raise the standard of living for the society in which it operates, to serve the interests of the society while satisfying the human needs of its employees, then hostile raids should not be permitted.

Very quickly, how should we stop them? First, by requiring responsible communications to the financial markets; and second, by requiring responsible financing in all acquisitions.

I do not believe the legislation is difficult to accomplish this responsibility and I have attached some ideas to my script on that subject. And let me add that most of these ideas are similar to those being suggested by the AFL-CIO.

There are no facts, in my view, to prove that hostile takeovers make American industry more efficient.

Thank you.

[The complete prepared statement of James K. Baker follows:]

Testimony Presented to the Banking Committee
of the United States Senate
March 4, 1987

Mr. Chairman, I am James K. Baker, Chairman and Chief Executive Officer of Arvin Industries of Columbus, Indiana. We are a $1.5 billion company with 18,000 employees, located in 15 states and 12 foreign countries. Arvin fought off a hostile raider in 1986. Also, as a director of 4 other companies, I have witnessed 6 additional hostile skirmishes, one of which was successful.

One of the major problems with successful hostile takeovers is that they take the "front end" out of the business. What do I mean by "front end"? It is like the front wheels on a car...they determine where the car is going. The front end of a business is its new products, its R & D, the automation of its factories, its long-term investments. Because hostile takeovers are leveraged, they cause the future cash flow of the business to be committed to debt and interest payments. Thus, eliminated are the products and programs that make up the front end of the business. Robbing the cash from the business eventually drains the vitality from the company. As a matter of public policy we must not rob American industry of its cash resources if they are to become and remain world class competitors. If this diversion of cash is permitted, we may just end up frying each other's hamburgers and pressing each other's pants!

A junk-bond leveraged buyout is the worst fate any company can experience. It drains the life blood from any manufacturing company.

Are friendly leveraged buyouts (LBO's) and management buyouts (MBO's) any better? No, for they, too, rob the most precious resource needed for the future health of the company...cash. In our own skirmish with a raider, we chose not to use an MBO as a defensive weapon for this very reason. We were not willing to rob our own company of its future cash by committing it to debt repayment.

If we stop hostile takeovers, we will stop LBO's and MBO's, because they are most often done in fear of the hostile raid. And if we stop hostile takeovers, there will be another benefit. Our brightest young minds will no longer want to be investment bankers. More of them will want to go into science, engineering and manufacturing. My son and my son-in-law are both in graduate business schools at this time. They report that their classmates want to go to Wall Street and get a starting salary of $100,000 --- and make a million dollars in 6-8 years. This is not idle talk --- this is the feedback they get from those that graduated ahead of them. Wall Street's takeover fees are outlandish. Our company was charged over one million dollars for a 60-day skirmish.

Joseph Auerbach of the Harvard Business School faculty said last month:

> "There is not one hostile acquisition that is based upon the kind of analysis we teach in business schools. The hostile acquirer doesn't know what is behind the balance sheet. He doesn't know what causes the income statement to be the way it is, and 10Q's and annual reports are not reliable for this purpose. We've all been directors; we know the problems inside the corporation. The hostile acquirer never knows them. He merely is measuring what can be financially driven for his own personal benefits."

This was true in our case -- our raider knew nothing of the strengths and weaknesses. His approach was to threaten me 2 to 3 times a day, including a threat to go public with a tender offer on Christmas Eve. This was no idle threat for he had done exactly that the previous Christmas Eve. Why Christmas eve? They know that there are times when the flow of market information is not efficient, and when it's difficult to make contacts with white knights, bankers, board members, etc.

Raiders have little respect for the SEC. They plan their surprise attacks to take maximum advantage of regulations, and to take maximum advantage of those periods when the flow of market information is far from perfect. They try to use the market; they are not responsible participants in it. None of the 7 hostile actions in which I've been involved have been driven by anything but greed. Do the raiders go after pension plan funds? You bet they do! Again, because of personal greed.

Let me close by saying a few words about the myth of "management entrenchment." There is no such thing. All people resist losing their jobs. Psychiatrists point out that loss of a job is very high on the list of emotional catastrophies. Management does fear the loss of their jobs AND the loss of jobs throughout their company. As we concluded our collective bargaining agreement last year, a UAW union leader extended his hand and said, "This is a good agreement. We think management is doing a good job. We hope no one takes over this company for we fear we might lose our jobs." Let me point out that after a hostile takeover, all jobs are at stake --- dedication, length of service, experience --- they mean nothing. Every company has an intangible, invaluable asset in its structures, philosophies, cultures, customs, and systems. When, in a hostile takeover, they are torn apart, we are tearing apart something that never can be put back together. Employees and communities pay the price. Factory workers, clerks, and research engineers pay the price --- not just "entrenched management."

Why are hostile raids possible? Not because of inept management. In our own case, Arvin was ranked in the top 10% of the Fortune 500 companies in performance. Forbes magazine ranked us 1st in our industry. We had split our stock twice and raised our dividends 3 times in 5 years. Earnings had grown 37% a year for 5 years. No, we were not inept. A company becomes a target because of a complex interaction of tax laws, interest rates, inflation and imperfect market communications that cause a company's future cash flow to be undervalued.

In our own case, we manufacture pollution control devices for cars and trucks. We poured tons of cash into the development of the catalytic converter for 15 years before finally perfecting it in 1973. Do you think our stock price was depressed during those 15 years? Certainly, it was. Should we embark today on another long, expensive, cash-draining R & D project with potentially great benefits to society in view of the possibility of a hostile takeover? How would you decide that question?

The CHAIRMAN. Thank you very much, Mr. Baker.

Our next witness is Donald Clark, chairman and CEO of Household International. Mr. Clark, go right ahead, sir.

STATEMENT OF DONALD C. CLARK, CHAIRMAN AND CEO, HOUSEHOLD INTERNATIONAL, PROSPECT HEIGHTS, IL

Mr. CLARK. Thank you, Mr. Chairman.

I appreciate this opportunity to appear before the committee to express the view that under our existing regulations takeovers deny value to a significant number of shareholders and these shareholders that are being denied value are usually the individual shareholders.

I also believe that takeovers impede the efforts of management as management attempts to maximize value over the long term. Greater pressure is being put on management to take its eye off the long-term prospects and emphasize short-term results.

I would hope that we could all agree that it is the role of management to maximize value over the long term. The corporate raiders and their supporters believe that the best way that boards can exercise this duty, this fiduciary duty, is to refrain from any action that might impede a tender offer just because that tender offer has a premium over market value.

SMITH V. VAN GORKEM

That the Delaware Supreme Court spoke pretty firmly in the *Smith* v. *Van Gorkem* case when it found that in that situation, where the premium was more than 40 percent of market value, the board may not have maximized value for the shareholders.

So I don't think we can just judge a premium on the basis of the market value. The market is not that efficient, although that is the basic position of the administration and the SEC and may explain why we have failed to get remedial regulations out of the SEC. They believe that this marketplace is efficient to the very dot.

I believe that when you look at the market price for a stock what you are seeing is the reflection of the value of 100 shares at that moment in time and that there should be a substantial premium for control of the corporation.

The widespread illegality that is being publicized underscores the point that the market is not an efficient vehicle.

Trying to keep management passive and focused on short-term results just plays into the hands of our foreign competitors and also into the hands of the raiders. Management has a responsibility to represent all shareholders, not just the institutional shareholders who emphasize short-term results.

I firmly believe that all tender offers, given the limited 20-day period in which shareholders and management have to react to an event that might well be a surprise—this makes, in my opinion, all tender offers coercive. We should have regulations that removes this pressure from the individual shareholder to make a decision in a very limited amount of time. It's unreasonable.

Under existing regulations the raider and his co-conspirators are able to secretly accumulate a substantial number of shares before they come public with the information. Value is being taken away from the individual shareholder because he's usually the one that they're buying the shares from and he is being denied the premium for control. This goes on because our current regulations permit this secretive accumulation.

Something else that strikes me as being overwhelming is the widespread illegality that is now being brought to light. This was not uncovered by effective regulation or control or disclosure. It all started with an anonymous tip. That in itself should be clear evidence that the rules are not adequate to protect the public.

I believe the other panel indicated that management itself is not free of criticism. I endorse outlawing greenmail and I endorse restraints on management. What we need in the marketplace is a greater balance and I've covered some specific recommendations in my written and more extensive testimony.

Thank you.

[The complete prepared statement of Donald C. Clark follows:]

The CHAIRMAN. Thank you very much, Mr. Clark.

Our next witness is Dr. Thomas Frist, chairman and CEO of Hospital Corp. of America

STATEMENT OF THOMAS F. FRIST, JR., CHAIRMAN OF THE BOARD, HCA, HOSPITAL CORPORATION OF AMERICA

Mr. FRIST. Thank you, Mr. Chairman. I'm Dr. Thomas Frist, Jr., and I am chairman of the board and chief executive officer of Hospital Corp. of America [HCA]. HCA is engaged in the business of owning, operating and managing hospitals in the United States and abroad. First incorporated in 1960, HCA today is a $5 billion company with over 70,000 employees which now owns or manages more than 460 hospitals in hundreds of communities throughout the United States.

HEALTH CARE INDUSTRY VULNERABLE TO TAKEOVERS

As the members of the committee are aware, the health care delivery environment in this country is rapidly changing, in great part as a response to the increased cost conscious behavior on the part of the major public and private purchasers of health care. The hospital industry in particular is currently out of favor in the stock market and as industry management attempts to deal appropriately with the changing health care environment, they find themselves vulnerable to takeovers with a short-term orientation.

In fact, one of the four largest hospital management companies is in the midst of a takeover attempt at this very time.

It is from this perspective of a publicly traded service company, contrary to most of the testifying CEO's today, the service company aspect providing essential public services within a volatile industry environment, that I wish to address my remarks.

Mr. Chairman, I would hope that the deliberations of your committee will not be conducted solely with a view toward protecting the investors in the equity markets. A public company, after all, is responsible to many stakeholders, only one of which is the equity stockholder. This is especially so when the corporation is the sole provider of vital services.

In our own case, for example, we are the only health care provider in 50 communities. Our own commitment to this concept of multiple stakeholders is incorporated in the last statement of our HCA mission, which says:

> The purpose of the company is to generate measurable benefits to the company, the medical staff, the employee, the investor, and most importantly, the patient.

It does not say:

> most importantly, the investor.

There is no doubt in my mind that a hostile, highly leveraged takeover has the potential of significantly harming each of these stakeholders.

Let me cover just one or two that I've provided in the written testimony.

The long-term debt holder, which accounts for 40 percent of HCA's investors, and I believe should be considered a shareholder, would see the value if his bonds—those pensions funds would see the value of their bonds severely eroded as debt credit ratings are lowered and some attention might be given by the committee to requiring a hostile takeover artist to make these investors whole as well as the stockholders.

The company, the community and the patient would find themselves, in the case of a hostile takeover, without vital emergency room, burn unit, obstetrical, or other essential nevertheless money-losing services that would inevitably be trimmed in order to meet short-term financial objectives.

Less profitable hospitals, which are often the rural sole community providers, would similarly be caught or closed, thus denying even basic hospital care to thousands and the uninsured or low margin Medicaid patient would find the remaining hospital doors closed for them.

The quality of medicine which our medical staff would be able to practice would erode as capital was diverted from necessary preventive maintenance, technological improvements, teaching and research, to nonproductive uses.

Finally, employees in a labor-intensive service industry would be laid off as staffing was reduced below acceptable levels and existing employee benefits for remaining workers would be threatened.

These are clearly unacceptable but very real outcomes of hostile takeovers. Mr. Chairman, I believe that many of the recommendations of my fellow panelists, including extended tender offer periods, single price, and 24-hour notice of tender, would well be considered.

Let me add to these the need to examine the area of corporate governance in which the rules and regulations let this all play out to enhance the decision-making role of the board of directors whose responsibilities are to the long-term interest of the company's shareholders.

Among some of the suggestions which I have submitted to you in written testimony and to the committee as a whole are that the board should be made up almost entirely, if not entirely, of outside directors. The chairman—and that includes myself—might well be nonmanagement, representing outside directors and the stakeholders.

Likewise, boards should have some protection from liability to ensure their independence and effectiveness.

In summation, Mr. Chairman, mechanisms must be adopted to limit the abuses which are occurring but at the same time responsiveness to the shareholder on the part of management must not be forsaken and, in fact, must be strengthened.

Thank you.

[The complete prepared statement of Thomas F. Frist, Jr., follows:]

In conclusion, if the corporation is in existence simply as a financial producing machine to satisfy its owners, then perhaps hostile takeovers are a valid part of that game. But, if the corporate purpose in America is to produce worthwhile products and services, to provide adequate returns for risk capital, to raise the standard of living for the society in which it operates, to serve the interests of that society while satisfying the human needs of its employees, then hostile raids should not be permitted.

How should we stop them? By requiring responsible communications to the financial markets and by requiring responsible financing in all acquisitions. I do not believe the legislation to accomplish this responsibility is difficult. I have attached some ideas on discouraging the hostile takeover process to my script. And, let me add that most of these ideas are similar to those being suggested by the AFL-CIO. There are no facts to prove that takeovers make American industry more efficient.

Thank you very much.

Legislative Proposals on Takeover Mergers

by
James K. Baker, Chairman
Arvin Industries, Inc.
Columbus, Indiana

Hostile takeovers are deemed undesirable for the future vitality and competitiveness of U. S. industry. The following legislative proposals are possibly all that is necessary to discourage or eliminate such takeovers. They fall into two categories: those changes needed to provide responsible communications with the financial markets and all shareholders, and those changes needed to bring responsible financing of all acquisitions.

Responsible Communications:

1. Require a filing with the S.E.C. and a simultaneous public disclosure to the stock exchange and the wire services at the close of the trading day in which the acquisition of 3% of a company's voting stock has occurred.
2. Require subsequent filings at the close of trading after the acquisition of additional voting shares totalling 0.5% or more.
3. Require the minimum tender offer period be changed to 90 days from 20 days.
4. Eliminate the creeping tender offer by requiring anyone owning 15% of the voting stock of a company to (a) file with the S.E.C. that no more stock will be acquired, or (b) require the filing of a tender offer before acquiring additional shares.

Responsible Financing of Acquisitions:

1. Require that 50% of any acquisition using debt be financed with cash.
2. Require that "excess" funds in pension plans not be recaptured for 5 years after the acquisition takes place.

TESTIMONY BY D. C. CLARK
CHAIRMAN, CHIEF EXECUTIVE OFFICER
HOUSEHOLD INTERNATIONAL
BEFORE THE U.S. SENATE COMMITTEE
ON BANKING, HOUSING AND URBAN AFFAIRS
MARCH 4, 1987

MY NAME IS DONALD CLARK. I AM CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF HOUSEHOLD INTERNATIONAL, A MULTI-BILLION DOLLAR DIVERSIFIED HOLDING COMPANY.

I COMPLIMENT YOU ON HOLDING THESE HEARINGS BECAUSE I BELIEVE WE ARE IN THE MIDST OF A CRISIS. A CRISIS OF CONFIDENCE IN OUR FINANCIAL SYSTEMS AND A CRISIS OF CONFIDENCE IN OUR FINANCIAL REGULATIONS.

WE AT HOUSEHOLD WERE THE SECOND COMPANY TO ADOPT A SHAREHOLDERS RIGHTS PLAN WHICH HAS BEEN DUBBED A POISON PILL BY ITS CRITICS. THE REASON WE ADOPTED THE PLAN AND MAINTAIN IT TODAY, IS THAT WE BELIEVE MANAGEMENT IS ILL-EQUIPPED TO REPRESENT ITS SHAREHOLDERS IN WHAT IS IN REALITY A HIGH STAKES GAME WITH A ONE SIDED SET OF PLAYING RULES FAVORING THE CORPORATE RAIDER.

HOUSEHOLD ADOPTED THE PLAN IN 1984 AT A TIME WHEN CORPORATE RAIDERS WERE TARGETING DIVERSIFIED COMPANIES AS UNDERVALUED BREAK-UP CANDIDATES. AVCO CORPORATION, A MULTI-BILLION DOLLAR CORPORATION IN BUSINESSES SIMILAR TO OURS, WAS UNDER ATTACK FROM A COMPANY 1/10TH ITS SIZE. WE AT HOUSEHOLD RECEIVED SEVERAL CALLS FROM INVESTMENT BANKERS PUTTING THEIR OWN RAIDING GROUP TOGETHER AND WE WERE ASKED WHICH PIECE OF AVCO WE WANTED. THEY WERE PUTTING TOGETHER A GROUP THAT WOULD PRE-COMMIT TO THE BUSINESS PIECES OF AVCO. SHARKS CIRCLING THE VICTIM.

THAT MANAGEMENT WAS ILL-EQUIPPED THEN AND STILL TODAY IS BECOMING CLEARER. THE INEFFECTIVENESS OF 13D FILING WHICH PERMITS SUBSTANTIAL ACCUMULATION BEFORE PUBLIC DISCLOSURE AND THE BLATANT DISTORTION OF THE REAL PURPOSE FOR THE ACCUMULATION IS NOW WELL DOCUMENTED. WE ARE JUST NOW SEEING SIGNS OF POSSIBLE MASSIVE ILLEGALITY IN PARKING SHARES AND COLLUSION ON THE PART OF CORPRATE RAIDERS AND THEIR ALLIES.

ALL OF THIS IS ENCOURAGED BY A MARKET IDEOLOGY THAT IS BASED ON THE BELIEF THAT WE HAVE AN EFFICIENT MARKET FOR THE PURCHASE AND SALE OF WHOLE CORPORATIONS AND THAT LIMITED OR NO REGULATION IS THE BEST REGULATION - THE SO-CALLED EFFICIENT, FREE MARKET THEORY.

WELL, TODAY WE ARE SEEING COMPANIES TREATED AS COMMODITIES TO BE BOUGHT AND SOLD "LIKE APPLES" FOR A PREMIUM WITH LITTLE REGARD AS TO WHETHER OR NOT THE PREMIUM REPRESENTS THE CURENT VALUE OF A LONG-TERM VIABLE ENTITY, AND WITH AN ALMOST TOTAL DISREGARD FOR THE INTERESTS OF CONSTITUENCIES OTHER THAN THE SHAREHOLDERS.

WE ARE WITNESSING A REAL LIFE MONOPOLY GAME, STILL PLAYED WITH PAPER MONEY -- BUT NOW CALLED JUNK BONDS.

MANAGEMENT IS BEING TOLD BY SOME TO BE A CARETAKER AND TO STAY OUT OF THE WAY OF THE SPECULATOR IN HIS ATTEMPT TO GAIN CONTROL OF A COMPANY, I.E., NOT TO INTERFERE IN THE TENDER OFFER PROCESS. THE DELAWARE COURTS, HOWEVER, AND TO THE CONTRARY HAVE CLEARLY SUPPORTED MANAGEMENT'S RIGHT AND INDEED ITS DUTY, TO REPRESENT SHAREHOLDERS IN THE FACE OF HOSTILE TENDER OFFERS. IN THE UNOCAL CASE, THE DELAWARE SUPREME COURT STATED, "WHEN A BOARD ADDRESSES A PENDING TAKEOVER BID, IT HAS AN OBLIGATION TO DETERMINE WHETHER THE OFFER IS IN THE BEST INTERESTS OF THE CORPORATION, AND ITS SHAREHOLDERS."

AS A PROFESSIONAL MANAGER, I BELIEVE IT IS AN IMPORTANT PART OF MY JOB TO REPRESENT THE DIFFERING INTERESTS OF SHAREHOLDERS AND OTHER CONSTITUENCIES IN ANY TAKEOVER SITUATION. THIS ACTIVITY IS DEMANDING MORE AND MORE OF MANAGEMENT'S TIME, FURTHER WEAKENING OUR EFFORTS TO REBUILD THE VITALITY OF CORPORATE AMERICA.

IT IS AN ANOMALY TO ME THAT A BOARD OF DIRECTORS MUST APPROVE A MERGER BEFORE THE SHAREHOLDERS CAN VOTE ON THE MERGER, BUT MANAGEMENT IS BEING TOLD TO STAY ON THE SIDELINES AND LET A TENDER OFFER, THAT INVARIABLY RESULTS IN A MERGER, GO TO THE SHAREHOLDERS, EVEN THOUGH TENDER OFFERS ARE INHERENTLY COERCIVE.

DOES ANYONE REALLY DOUBT THAT A RAIDER WISHES TO BUY THE SHARES AT THE LOWEST POSSIBLE PRICE FROM A SHAREHOLDER GROUP SCATTERED AND UNREPRESENTED BY A VIGILANT MANAGEMENT?

IN THIS THE RAIDER AND HIS CO-CONSPIRATORS ARE ASSISTED BY THEIR ABILITY TO SECRETLY ACCUMULATE A SUBSTANTIAL OWNERSHIP POSITION AT PRICES SIGNIFICANTLY BELOW THE EVENTUAL TENDER PRICE. IN ADDITION, WE ARE JUST BEGINNING TO LEARN ABOUT THE INHERENT WEAKNESSES IN OUR CURRENT REGULATIONS WHICH HAVE ALLOWED THE WIDESPREAD ILLEGAL BEHAVIOR OF A GROWING NUMBER OF PLAYERS IN TODAY'S TAKEOVER GAME. IT FRIGHTENS ME TO REALIZE THAT THE CURRENT INVESTIGATIONS STARTED FROM AN ANONYMOUS TIP AND NOT FROM AN EFFECTIVE DISCLOSURE OR ENFORCEMENT PROCEDURE.

MANAGEMENT IS NOT FREE OF CRITICISM FOR ACTIONS THAT INVOLVE GREENMAIL AND ELEMENTS OF ENTRENCHMENT. BUT, I BELIEVE THAT FOR THE MOST PART, AMERICAN MANAGEMENT DOES TAKE ITS RESPONSIBILITY TO MAXIMIZE SHAREHOLDER VALUE VERY SERIOUSLY.

WHAT WE NEED IS A BALANCE OF RESTRAINTS AS OPPOSED TO THE CURRENT ENVIRONMENT THAT CLEARLY FAVORS THE RAIDER.

THERE ARE OTHER SIGNIFICANT NATIONAL INTERESTS INVOLVED THAT GO BEYOND THE QUESTION OF HOW A CHANGE IN CONTROL OF A CORPORATION SHOULD BE EFFECTED.

OUR BEST AND BRIGHTEST STUDENTS ARE BEING LURED INTO THE TAKEOVER GAME WITH PROMISES OF WEALTH BEYOND COMPREHENSION. PEOPLE ARE RIGHTFULLY QUESTIONING THE PRODUCTIVITY OF THESE EFFORTS AND WHETHER OR NOT WE ARE BUILDING A NEW CORPORATE STRUCTURE ON A BASE OF SAND THAT IS SO OVERBURDENED WITH THE NEED FOR SHORT-TERM RESULTS, THAT THE BASE WILL BE WASHED AWAY WITH THE CONTINUING FLOOD OF IMPORTS.

THESE AND OTHER ISSUES JUSTIFY A REVIEW BY YOUR COMMITTEE OF THE FULL RANGE OF CONSEQUENCES OF OUR PRESENT STRUCTURE.

AS A MANAGER, I AM CHALLENGED TO RECOGNIZE THE CONFLICTING INTERESTS OF MY MANY CONSTITUENCIES, INCLUDING THE DIFFERENT INTERESTS OF MY BASIC SHAREHOLDER GROUP. MY BELIEF IN ONE SHARE, ONE VOTE IS BEING CHALLENGED BY THE RECOGNITION THAT THERE IS AN INCREASINGLY ACTIVE GROUP OF SHAREHOLDERS THAT HAVE LITTLE OR NO INTEREST IN THE LONG-TERM VITALITY OF A COMPANY. THEY ARE, IN REALITY, SPECULATORS AND NOT SHAREHOLDERS. SHOULD SOMEONE WHO ACCUMULATES STOCK TO PUT A COMPANY INTO PLAY FOR SHORT-TERM GAIN HAVE AN EQUAL VOTE WITHN SOMEONE WHO IS LOOKING FOR A LONG-TERM RELATIONSHIP? IS IT NOT AKIN TO A GROUP OF VOTERS BEING ALLOWED TO MOVE ACROSS A STATE LINE TO INFLUENCE THE OUTCOME OF A SENATORIAL ELECTION, AND THEN MOVING ON TO THE NEXT STATE WHEN THE DAMAGE IS DONE? I AM LEANING TOWARD THE NEED FOR SOME RESIDENCY (LONG-TERM OWNERSHIP) REQUIREMENT TO REFLECT WHAT I WOULD TERM REAL OWNERSHIP INTERESTS.

I DON'T INTEND TO COVER ALL OF THE ISSUES I BELIEVE THAT THIS COMMITTEE SHOULD ADDRESS. I TRUST THAT YOU WILL EVENTUALLY HEAR THEM ALL. I WOULD, HOWEVER, LIKE TO CLOSE BY ASKING YOU TO CONSIDER A FEW SPECIFIC RECOMMENDATIONS:

1) EXTEND TENDER PERIODS FROM 20 TO 90 DAYS. AN EXTENDED PERIOD WOULD PERMIT A SHAREHOLDER VOTE DURING THE TENDER PERIOD.

2) REQUIRE IMMEDIATE DISCLOSURE WHEN A 1% OWNERSHIP POSITION IS ACCUMULATED AND IMPOSE A TEN-DAY WAITING PERIOD BEFORE FURTHER ACCUMULATION. WE SHOULD ALSO REQUIRE A STATEMENT AS TO WHETHER OR NOT THE BUYER KNOWS OF OTHERS WHO ARE ACCUMULATING SHARES.

3) RIGHT TO VOTE ON A MERGER OR A TENDER SHOULD BE LIMITED TO THOSE WHO OWN STOCK FOR A MINIMUM PERIOD - PERHAPS ONE YEAR.

4) ONE PRICE -- 100% OFFER -- NO TWO-TIER OR PARTIAL OFFERS.

5) NO GREENMAIL WITHOUT SHAREHOLDER VOTE.

6) LIMIT JUNK BONDS OWNED BY FEDERALLY INSURED INSTITUTIONS AND CONSIDER TAXING JUNK BONDS.

IF THE FOREGOING LEGISLATIVE PROPOSALS WERE ENACTED, I WOULD BE WILLING TO RECOMMEND TO MY BOARD THAT OUR OUTSTANDING SHAREHOLDER'S RIGHTS OR, IF YOU WILL, "POISON PILL" BE REDEEMED.

Thomas F. Frist, Jr.
Chairman of the Board
HCA The Healthcare Company

My name is Thomas F. Frist, Jr. and I am Chairman of the Board of Directors and Chief Executive Officer of HCA The Healthcare Company.

HCA is engaged in the business of owning, operating and managing hospitals in the United States and abroad. First incorporated in 1960, HCA now owns or manages more than 400 hospitals in hundreds of communities throughout the United States.

As the members of this committee are aware, the health care delivery environment in this country has been rapidly changing, in great part as a response to increased cost conscious behavior on the part of major public and private purchasers. The hospital industry in particular is currently out of favor in the stock market and as industry management attempts to deal appropriately with the changing health care environment they find themselves vulnerable to takeovers with a potential short term orientation. In fact, one of the four largest hospital management companies is in the midst of a takeover attempt at this time.

It is from this perspective of a publicly traded company providing essential public services within a volatile industry environment, that I wish to address my remarks today.

Mr. Chairman, this committee has been presented with voluminous testimony thoroughly examining the financial implications of hostile takeovers and suggesting a variety of remedies to correct abuses. I would hope, however, that these deliberations not be conducted solely with a view toward protecting the investors in the equity markets.

A public company after all is responsible to many "stakeholders", only one of which is the stockholders. I have long felt that a company is created to meet a need in society and only so long as it can do so in a responsible manner will society continue to grant it the privilege of serving it.

This is especially so when the corporation is the sole provider of vital services. In our own case for example, we are the only health care provider in over 50 communities.

Our own commitment to this concept of multiple stakeholders is incorporated in a concise Mission statement that is printed in every annual report, prominently displayed in every hospital for our employees and patients to see and is repeatedly underscored to our investing public by management in various forums throughout the year. The conclusion of that statement reads:

to generate measurable benefits to

The Company
The Medical Staff
The Employee
The Investor
and most importantly, the Patient.

This is no doubt in my mind that a hostile, highly leveraged, and especially junkbond financed, takeover has the potential of significantly harming each of these stakeholders:

- The long-term debt holder which accounts for 60% of HCA's investors and in a majority of cases is an institutional investor such as a pension fund, would see the value of his bonds severely eroded as debt credit ratings were lowered.

- The community and the patient would find themselves without vital emergency room, burn unit, obstetrical or other essential but nevertheless, money losing services which would inevitably be trimmed in order to meet short-term financial objectives. Important teaching and research would most likely be eliminated. Less profitable hospitals, which are often the rural sole community providers, would similarly be culled or closed; thus denying even basic hospital care to thousands. And the uninsured or low margin medicaid patient would find the remaining hospital doors closed for them.

- The quality of medicine which our medical staffs would be able to practice would erode over time as capital was diverted from necessary preventive maintenance and technological improvements.

- Finally, employees would be laid off as staffing was reduced below acceptable levels and existing employee benefits for remaining workers would be threatened.

These are clearly unacceptable but yet very real outcomes of takeovers characterized by short-term maximization of profits, stockprice or asset value for the benefit of a few to the detriment of the many.

Mr. Chairman, my fellow panelists have discussed in detail the limitations which the committee should carefully consider imposing in order to address takeover abuses and these unacceptable outcomes. I believe that many of these recommendations including extended tender periods, single price, and 24-hour notice of tender, would be well considered.

The CHAIRMAN. Thank you, Mr. Frist.

Our next witness is William Howell, chief executive officer of J.C. Penney Co. We're delighted to have you, Mr. Howell. Go right ahead.

STATEMENT OF WILLIAM R. HOWELL, CHAIRMAN OF THE BOARD AND CEO, J.C. PENNEY CO., INC.

Mr. HOWELL. Good morning, Mr. Chairman, thank you.

J.C. Penney is one of our Nation's largest general merchandise retailers with stores in all 50 States. We employ about 175,000 associates. We also serve consumers across America through our catalog operation as well as our consumer financial services division.

I indeed appreciate the opportunity this morning to appear before you to share my concerns on an issue of vital importance, I think, to all of us—hostile corporate takeovers.

Judging from the headlines, I think one might believe that the insider trading scandal is the most serious issue affecting Wall Street. As concerning as that is to me and to all of us, the apparent increase in the exchange of insider information is, in our opinion, symptomatic of a more serious problem—high stakes, hostile takeovers.

What truly concerns the managers of American businesses is the ability of a group of corporate raiders, arbitrageurs, investment bankers, and lawyers to place a well-managed company in play and realize a financial windfall from the resulting chaos. At one time, investors—individuals and institutions alike—purchased stock because they believed in the company that issued it and management's ability to make the firm grow and prosper over the long term.

Today, raiders and their associates have found that they can exact large personal profits by focusing on the runup in value of stock prices caused by the process of a corporate takeover.

SERIOUS THREAT TO OUR ECONOMIC AND FINANCIAL SYSTEM

It is this focus on quick bucks—viewing takeover victims as cash cows to be milked and discarded—that seriously threatens our economic and financial system.

Corporate restructuring and changes in management are not new developments of the 1980's. However, there is a difference between corporate transactions of the past and current takeover abuses. These abuses have been well documented in previous testimony.

My personal concern this morning is that this takeover—induced focus on short-term profits, if it continues unabated, will seriously undermine the ability of prudent managers to run their businesses as they should.

In our country, private enterprise and major corporations, in particular, have been expected to play a variety of roles, as has already been mentioned. They must serve customers by providing goods and services in an efficient manner and in a way which enables them to provide their owners, the shareholders, with an adequate return on their investment.

In addition to these pure economic goals, our companies are challenged with a greater responsibility. They are expected to recognize and serve the needs of the communities in which they operate, to provide continuity of employment, to assist in the realization of domestic and foreign policy, and to otherwise function as good corporate citizens.

The threat of a takeover with its prospect of bloated profits to market professionals forces corporate management to ignore its broader responsibilities and to focus instead on managing the company with a view toward maximizing short-term earnings and stock prices.

This atmosphere discourages corporate managers from making capital investment or exploring new product development which do not have an instant payoff.

Let me give you a real example from my own company's experience. The J.C. Penney Catalog offers consumers the opportunity to order merchandise for home delivery anywhere in the United States. The quality of our merchandise and the efficiency of our ordering and delivery operation has met with outstanding consumer support.

Started in 1964 in Milwaukee, WI, our catalog division has seen its sales volume grow from $45 million in that first year of operation to $2.3 billion this past year.

The CHAIRMAN. Where did you say it started?

Mr. HOWELL. In Milwaukee, WI, Mr. Chairman.

The CHAIRMAN. Right on. No wonder it grew that way.

Mr. HOWELL. It was a friendly acquisition of the General Merchandise Co. in Milwaukee, WI in 1964.

The J.C. Penney Catalog is now the second largest operation of its type in the world and has become a major contributor to J.C. Penney's bottom line. In fact, a significant portion of our earnings increase just this past year was attributable to this division and we dedicated our 1986 annual report to the 16,000 catalog associates.

Achieving this success required the investment as you can imagine of considerable capital. We have invested in large catalog distribution centers throughout our Nation—Connecticut, Ohio, Wisconsin, Georgia, Kansas and Nevada. These centers cost in current dollars about $150 million each. They pay substantial amounts in taxes to the Federal, State, and local governments. They each employ an average of 1,500 people and have an annual average payroll of $25 million.

When we embarked on this program, we were required to make long-term commitments. We operated the program for a number of years in the red, but we were confident—at least comfortable—that it would ultimately return to the shareholders an acceptable level of return.

My reason for mentioning that is only to bring to light that in the present environment it becomes increasingly difficult for a management team to make those long-term commitments when there is so much focus on the short term.

The long-term interest of a well-managed corporation seldom, if ever, coincides with the short-term cash concerns of the corporate raider. We must preserve the ability of corporate managers to plan for the future.

At a time when economists are concerned about the Nation's low savings rate and the huge Federal budget deficit, we can ill afford to allow the country's largest corporations to be driven in the same direction.

Mr. Chairman, we must return to the original meaning of investment—the outlay of capital with a return of income and profit in the future. Only with that focus can we, the current stewards of corporate America, truly serve our American economy.

Thank you very much.

[The complete prepared statement of William R. Howell follows:]

But if limitations are to be placed on takeover specialists, arbitrageurs, institutional holders, investment bankers and insiders, then management must be prepared to accept mechanisms which will make them even more responsive to the shareholder and the public. Balancing the playing field should also be accompanied by efforts on our part in the area of corporate governance to enhance the decision making role of the Board of Directors whose responsibilities are to the long-term interests of the company's shareholders.

To that end we must be prepared, I believe to accept the following measures:

- Boards should be made up almost entirely of outside directors. Apart from the C.E.O., the number of inside directors should be limited by the percentage of stock owned by management.

- A significant part of the compensation of directors should be in the form of stock options to create an identity of interest which shareholders.

- Accounting firms must be forced to shift their allegiance from management to the Board.

- Institutional investors must pay more attention to the quality of directors.

In summation, Mr. Chairman, takeovers can and do exert a positive discipline on management and often inure to the benefit of the shareholder. However, when the playing field is significantly tilted as it is now, abuses which produce highly undesirable consequences for classes of shareholders or other equally important stakeholders are likely to be the outcome.

Mechanisms must be adopted to limit the abuses which are occurring but at the same time responsiveness to the shareholder on the part of management must not be forsaken and in fact must be strengthened.

This concludes my remarks, Mr. Chairman. I would be pleased to answer any questions.

STATEMENT

OF

WILLIAM R. HOWELL

Mr. Chairman and Members of the Committee:

I am William R. Howell, Chairman of the Board of JCPenney Company, Inc. JCPenney is one of the world's largest general merchandise retailers, with stores in all 50 states, and more than 175,000 employees. We also serve customers through the JCPenney Catalog and are a major provider of consumer financial services, including consumer credit and insurance. I appreciate the opportunity to appear before you today to share my concerns on an issue of vital importance: hostile corporate takeovers.

Judging from the headlines, one might believe that the "insider trading scandal" is the most serious issue affecting Wall Street. That is not so. Insider trading is a serious issue, and strong enforcement of the laws against trading abuses is obviously needed. But the apparent increase in the exchange of inside information is actually symptomatic of a more serious problem: high stakes hostile takeovers. What truly concerns the managers of America's businesses is the ability of a group of corporate raiders, arbitrageurs, investment bankers, and lawyers to place a well-managed company "in play" and realize a financial windfall from the resulting chaos.

There is a fundamental change occurring in the marketplace. At one time, investors -- individuals and institutions alike -- purchased stock because they believed in the company that issued it and its managers' ability to make the firm grow. Today, raiders and facilitators of corporate takeovers have found that they can exact large personal profits by focusing on the run-up in value of stock prices caused by the process of a corporate takeover. To some degree, these profits can be earned regardless of the underlying intrinsic value of the company placed in play. It is this focus on "quick bucks" -- viewing takeover victims as nothing more than "cash cows" -- that seriously threatens our economic and financial system.

In our country, private enterprise, and major corporations in particular, have been expected to play a variety of roles. They must serve their customers by providing goods and services in an efficient manner, and they must do so in a way which enables them to provide their owners -- the shareholders -- with an adequate return on their investment.

In addition to these pure economic goals, our companies are challenged with a greater responsibility: they are expected to recognize and serve the needs of the communities in which they operate, to provide continuity of employment, to assist in the realization of domestic and foreign policy, and to otherwise function as good corporate citizens.

I think it is fair to say that, until recently, corporations were generally meeting these challenges and fulfilling the goals expected of them. In order to continue to perform as the public and our stockholders expect, however, a corporation must be permitted to take the long view -- to function with a mind towards maximizing real value, with all that implies. It should not be forced into decisions or courses of action which ignore real value and have, as their sole objective, the realization of short-term profits.

It is with this background in mind that I believe the current takeover activity must be considered. Corporate restructuring and changes in management are not new developments in our economy. We have had mergers, acquisitions and proxy fights for a long time, and I expect that we shall always have them. However, there is a difference between corporate transactions of the past and current takeover abuses. These abuses have been well-documented in previous testimony. My personal concern, however, is that this takeover-induced focus on short-term profits, if it continues unabated, will seriously undermine the ability of prudent managers to run their businesses.

Based upon my experience and that of my colleagues who run major United States corporations, I believe that the current wave of hostile takeover battles is not good for the economy, society, or the country. The primary message these battles teach is that "good management" is one whose primary responsibility is to maximize current stock price. All other factors should be ignored: forget about research and development, forget about long-range investment and capital formation, forget about the private sector making up for some of the social cuts in our budget, and forget a host of other activities. If you can raise the stock price today, do it -- even if it means dismantling the corporation, liquidating it, or leveraging the company into debt. Lest you refuse to take these steps, you're labeled a "bad" manager -- one whose sole interest is in staying entrenched and one who obviously has no interest in his shareholders. Worse, a manager refusing to take these steps also makes his company a target.

Such a situation is dangerous. Given the increasingly competitive nature of the global marketplace, we cannot afford to have our corporations' top managers operating with a "live for today, worry about tomorrow" attitude.

The problem with the current environment, particularly as it regards corporate takeovers, is that once the tender offer process begins, there is little likelihood that the company will remain independent. Let me elaborate:

A would-be acquirer identifies a potential target company. The prime consideration is that the value of the target's assets exceeds in the aggregate the stock market price of the company. In essence, the various parts of the target are thought to be worth more than the whole -- as reflected by stock price. Having identified a potential target, the acquirer begins to accumulate the target's shares. Eventually such an accumulation will be signaled to the market -- either by press reports or by the filing of a Schedule 13D with the SEC when the acquirer reaches an ownership level of 5% of the issuer's outstanding stock.

Once the market has been signaled that a company is "in play," and that a well-heeled and credible "investor" is accumulating, the company's stock price rises and the traditional institutional investors sell -- content to take immediate short-term profits. With the traditional institutions selling, the arbitrageurs and speculators begin buying the target's stock in large quantity in order to make a profit between their purchase price and either the anticipated offering price, or the price that a "white knight" will ultimately pay. At this point, it is the takeover process which is yielding profits, not the intrinsic value of the company. And, although the arbitrageurs and speculators are the "shareholders" controlling the future of the target, they want quick short-term profits, since they have financed a portion of their purchases and the carrying costs become expensive. As such, they will sell their holdings readily.

Takeover battles not only distort management behavior, they also disrupt it. All managers can do is try to fend off the raiders long enough to get a better price for their shareholders. The managers thus find themselves in the business of fighting control battles instead of in their real business of running companies, and making them productive and competitive.

The long-term interests of a well-managed corporation seldom, if ever, coincide with the short-term cash concerns of the corporate raider. Long-term corporate growth requires manageable debt, research and development, continuity, and a dedicated, loyal workforce.

Companies, just like individuals, must keep their debt load at a manageable level. To the extent that debt allows companies to make productive investments in plants, equipment, new technology and services at the most opportune moment, it is a benefit. But when the debt level rises so high that it begins to drive corporate decision-making, problems develop. Companies whose debt levels are not supported by true asset value cannot properly respond to financial reversals.

Well-managed companies must also be willing to make necessary investments in research, development, and new ventures which may not yield an immediate pay-off. Prudent management nurtures various, oft-times initially unprofitable, projects that hold the potential to enhance the company's operations and income in the future. In my industry, retailing, we operate in a highly competitive environment; margins are relatively low, and there is a constant need for substantial capital expenditures to ensure long-term growth. While research and development, as such, may not be as significant in retailing as in the higher technology industries, we are continually seeking to improve our productivity in marketing and distribution, all in an effort to serve the needs of consumers.

Our catalog operation is a good example. The JCPenney Catalog offers our customers the opportunity to order merchandise for home delivery anywhere in the United States, generally within 48 hours. The quality of our merchandise, and the efficiency of our ordering and delivery operation, has met with outstanding consumer support. Started in 1964 in Milwaukee, Wisconsin, our Catalog division has seen its sales volume grow from $45 million in the first year of operation to $2.3 billion last year. The JCPenney Catalog is now the second largest operation of its type in the world, and the program has become a major contributor to our "bottom line." In fact, a significant portion of our earnings increase last year was attributable to Catalog -- and we dedicated our 1986 annual report to our 16,000 Catalog associates.

Achieving this success required considerable expenditures of capital. We invested in large Catalog distribution centers in Connecticut, Ohio, Wisconsin, Georgia, Kansas and Nevada, which cost, in current terms, on the order of $150 million each. These centers employ an average of 1,500 people each, have an average annual payroll of $25 million, and are each expected to yield $400 million in business this year. They all generate substantial federal, state and local tax revenues.

We were required to make a long-term commitment of resources to the Catalog business. We operated the program for a number of years before it became profitable, confident -- or at least hopeful -- that it would ultimately meet with an acceptable level of consumer support.

Other large long-term investments include JCPenney's wholesale distribution centers. One center in California covers 1 million square feet and has a payroll of $9 million. That center would cost about $50 million to build today. Another large center, in North Carolina, has a payroll of about $8 million.

The economic importance of both our Catalog and wholesale distribution centers goes far beyond the payroll or the amount of merchandise that each center handles. These operations purchase supplies, use utilities, employ security, and secure transportation from local firms -- causing a multiplier effect on local economies. Their employees buy houses, clothing and other goods and services in the local area.

My reason for discussing these programs is simply to question whether managers in today's environment would have the determination of my predecessors to make such a substantial long-term commitment of resources in the hope of a return perhaps years later. In evaluating a similar long-term, high cost venture today, many would be inhibited by concerns about the project's impact on short-term earnings, and its potential for making the corporation more vulnerable to a hostile takeover attempt. In short, the atmosphere which exists today adds an additional and unfortunate level of concern to the pure business considerations which should motivate the corporate manager.

In spite of these concerns, we believe we must continue to plan for the future. A very recent example of a long-term investment is our launching of the first consumer-controlled, cable television home shopping service, called "Telaction." Telaction will provide the consumer with an electronic assortment of department stores, specialty stores, international stores, travel reservations, ticketing services, groceries, and other convenience products and services. JCPenney has budgeted $40 million to develop the technology and cover the cost of Telaction's market introduction. Telaction is a project with great promise for the future -- but one which involves significant technological and market risks in the near term. However, unless companies are willing to take present risks -- even though profits will have to be postponed to the future -- they will not expand and grow to serve the public as it expects to be served. We make this investment, despite knowing that, in the current environment, we simply do not have the same freedom to nurture new projects as we did at the time we began our Catalog division.

As the threat of takeovers increases, the planning horizon of companies is brought closer to the present, and major long-term investments such as this may not be undertaken. In the rush for the bottom line, potentially profitable divisions may be spun off before they have a chance to prove their worth. The consumer and the economy will suffer because productive investments will be set aside in an attempt to forestall hostile takeovers.

As this Committee is well aware, the debt load of America's companies is rising. Much of this debt is not supported by the true value of the companies involved. I am afraid that, in the next economic down-turn, many highly leveraged companies may suffer serious reversals. Indeed, in view of this, my Company has been working to reduce our overall debt load.

Unfortunately, this "debting up" of U.S. corporations is also jeopardizing the nation's financial health. Junk bonds are being purchased by insured banks, and acquired by pension fund managers, in an effort to increase their funds' yields. In a financial crisis or economic down-turn, if companies begin to default on these obligations, society as a whole will be forced to pick up the tab. Whether it is through new taxes to make up shortfalls in the banking insurance system, or increases in Social Security to compensate for under-funded pension plans, society will pay twice -- once in diminished productivity and again to make up these losses.

The fear of falling prey to a takeover, with its prospects of bloated profits to individuals who may have recently acquired their shares from less-knowing shareholders, has forced corporate management to ignore its broader responsibility and focus instead on managing the company solely with a view towards maximizing short-term earnings and stock prices. No longer can the corporate manager safely decide whether a particular capital investment or a new product development is, in fact, in the long-term interests of its customers, suppliers, employees and owners.

I have not mentioned the disruption caused by the hostile takeover itself. Beyond the months of uncertainty and the loss of productivity, as management becomes preoccupied with the hostile takeover effort, there are the additional problems that arise if, and when, the takeover is successful. There is a learning curve for new management and the company pays a price for it.

An occasional shake-up of management can be beneficial; my managers are well aware of that. But the wholesale grafting onto a company of new managers who have little sense of the company's inner behavior, and who, by reason of the price they have paid for that company, have no choice but to focus on the short-term, may force the company into a strait-jacket that more reflective management would avoid.

Continuity and loyalty of management are also important. Ideally, managers should be intimately aware of their company's past, its strengths and its weaknesses. Only those who know what a company can do best, and what it has the potential to do better, can truly maximize their company's long-term potential.

Finally, and most dispiriting, a further consequence of hostile takeovers is the demoralization of the workforce. When existing employees see their co-workers thrown out of their jobs to accommodate the inevitable reorganizations, the entire workforce suffers. Due to the expenses involved in both hostile acquisitions and defenses, regardless of whether the takeover is successful, the company's assets may be sold to finance the cost of the battle. Workers become preoccupied with holding on to their jobs or finding others. Not only does news of layoffs send a malaise throughout the divisions of the company, it can affect even those not employed by the target firm. The massive layoffs resulting from some takeovers affect entire communities. In the interests of enriching a few, many suffer. Members of this Committee are well aware of the devastating impact that loss of company facilities can have upon a community.

Beyond these effects at home, the current wave of hostile takeovers is affecting U.S. companies' ability to compete abroad. By burdening our companies with debt and fixing their sights on the short-term, we are curtailing management's ability to develop a blueprint for international competition.

The President and Congressional leaders have stated that enhancing the "competitiveness" of U.S. industry is a top priority issue. This means, in part, increasing corporate productivity. Improved productivity, in turn, requires higher levels of savings and investment and a long-term commitment to research and development. Takeovers are counterproductive to this effort. Instead of increasing savings and investment, they increase debt. Corporate energies and resources are diverted to activities that are non-productive and long-term projects take a back seat to expedient profits.

I am aware that a number of bills have been introduced which address some of the problems, and I understand that other proposals are expected. I am encouraged by the apparent willingness of Congress to deal with this problem. Of particular interest to me are proposed modifications to existing requirements governing tender offers, to provide affected parties with the information and time they need to make informed decisions. The various proposals to narrow the Williams Act's 10-day window and the proposals to lengthen the tender offer review period are steps in the right direction and deserve careful consideration by this Committee.

In summation, I would like to make two points very clear. First, I am not endorsing unresponsive, entrenched management. Consistently poor performers should be removed. In this regard, I would like to point out that retailing is so highly competitive that companies will not survive if they are not run efficiently. There are many examples of retailers going out of business as a result of normal competitive forces (W. T. Grant, E. J. Korvette, Ohrbachs and Gimbels).

Secondly, I am not opposed to corporate takeovers as such. But the pendulum has swung too far. The current takeover frenzy puts the good manager at risk as well as the bad; the well-managed company as well as the poor. It also disregards the health of communities and shatters the financial lives of thousands of individuals. Attached to my statement are two recent newspaper articles which deal with these aspects of the takeover controversy. The first, which appeared in the Washington Post on February 27, 1987, discusses the takeover of one of the major retail firms, Allied Stores, and its impact on the Garfinckel's department store division here in Washington, D. C. The second article, from the same day's New York Times, entitled "So Much for Managers' Loyalty," describes the effect of the hostile takeover atmosphere on the morale of managers at all levels of our corporations.

We must preserve the ability of corporate managers to plan for the future. At a time when economists are concerned about the nation's low savings rate and the high federal budget deficit, we can ill-afford securities laws that allow the country's largest corporations to be driven in the same direction. We must return to the original meaning of "investment:" the outlay of capital for the return of income and profit in the future. When that focus returns to Wall Street, the current scandal will be seen for the footnote that it is. But unless it returns, I believe that we will have failed to serve the best interests of the American economy.

RUDOLPH A. PYATT JR.

THE WASHINGTON POST
FRIDAY, FEBRUARY 27, 1987

Garfinckel's a Victim in Takeover Game

Word this week that Garfinckel's probably will have a new owner by April all but completes the latest chapter in the history of a once proud retail organization. More than that, however, Garfinckel's imminent sale all but culminates the cannibalization of a company through hostile takeovers.

It could be said that the Garfinckel's story is a case study in the negative consequences of predatory acquisitions. It's yet another story of the dismantling of a company to satisfy gargantuan egos and corporate appetites.

Twice in less than six years, Garfinckel's, once the flagship division of a leading department and specialty-store chain, has changed hands. Twice the course of business at Garfinckel's and stores in its chain has been altered drastically by hostile takeovers. Now some new owner(s) will attempt to give the 10-store specialty retailer new direction, a new management philosophy and possibly a new identity.

Two or three years from now, Garfinckel's could be up for sale again or seized in another hostile raid.

No wonder industry sources say Garfinckel's is marginally profitable. Stability hardly could have been its strong suit amid the uncertainty of the past six years. Continuity in management at the local level notwithstanding, new owners never seemed quite able to settle on the right niche for the high-fashion retailer that Garfinckel's had become before the raids started.

Indeed, the fate of Garfinckel's tends to strengthen the argument that hostile takeovers often are more disruptive than constructive. In the case of Garfinckel's and associated chains, for example, we have a case study in the buying and selling of companies by investors who either didn't understand the business they targeted, had little interest in seeing it expand, or stripped it of valuable assets to finance the acquisition.

It's possible that, in the absence of a hostile takeover, Garfinckel's performance during the past six years might have been disappointing. It seems more likely, in hindsight, that pretakeover management was better equipped to guide the company's growth, even if it meant restructuring Garfinckel's and associated chains.

Ten years ago, Garfinckel's, Brooks Brothers, Miller & Rhoads Inc. announced plans for an ambitious expansion program. The corporation was positioning itself for what chairman and chief executive officer David R. Waters termed "superior growth and profitability." Waters outlined goals calling for rapid expansion of the corporation's markets and a doubling of sales and earnings within five years. Significant opportunities lay in specialty retailing, he said.

Thus Garfinckel's launched an aggressive expansion program, seeking opportunities in such diverse areas of retailing as home improvement, sporting goods stores and catalogue sales and showrooms. The corporation got rid of its ailing Joseph R. Harris division and acquired the trendier Ann Taylor women's apparel chain and Catherine's Stout Shoppes, a chain of nearly 100 stores specializing in clothing for large women.

The strategy proved ironically to be Garfinckel's downfall. Although the Garfinckel divisions included the venerable Brooks Brothers chain, the corporation was not considered a major national retail organization. Its Garfinckel's chain, though a leading Washington retailer, wasn't well known outside the area. But substantial earnings increases, acquisitions and expansion of existing divisions—including a Brooks Brothers joint venture in Japan—gave Garfinckel's new blood. It also attracted the sharks.

First, Allied Stores Corp. of New York launched a hostile takeover, only to be rebuffed initially by management. But Allied prevailed and Waters, who bitterly criticized Allied and its chairman, Thomas Macioce, quit shortly after the takeover.

Last year Allied became the target of Canada's Campeau Corp. and agreed to a merger after attempts to block a takeover failed.

Campeau, a giant real estate developer, promptly announced that it would have to sell Garfinckel's, Miller & Rhoads and perhaps as many as a dozen other Allied properties to help finance the $3.6 billion takeover.

Garfinckel's marginal profitability is said to be the overriding factor in Campeau's decision to get rid of it. But it soon became apparent that Allied didn't or couldn't develop the right specialty retail strategy for Garfinckel's. Campeau did exactly what was expected. It knew it would have to dismantle Allied to finance its $3.6 billion acquisition.

Garfinckel's is a small regional chain. The fact that it's in one of the most lucrative retail markets is irrelevant.

Even if it were more than marginally profitable, it's unlikely that Campeau would have kept it. So it was expected to be added to the growing list of so-called expendables in the current wave of dismantlings.

THE NEW YORK TIMES, FRIDAY, FEBRUARY 27, 1987

So Much for Managers' Loyalty

By Paul M. Hirsch

CHICAGO

On a visit to the Graduate School of Business at the University of Chicago two years ago, T. Boone Pickens, the corporate takeover specialist, joked that if he ever needed a heart transplant he hoped the donor would not be an arbitrager. Why? Because the heart would never have been used, he said.

We all laughed at the time, but the widening scandal on Wall Street makes Mr. Pickens's remarks all the more cogent. The recent bombshells about insider trading fall right in the middle of a heated battle over who gets to define the very purpose of a large corporation.

Lined up on one side are those who traditionally have felt some stake in a company — management, employees and the local community. They share a view of "their" company as a living resource whose continued existence as a major producer of goods, services, jobs and charitable donations seems etched in stone.

Recently, however, Wall Street has successfully attacked this view, leading the charge for a redefinition of the corporation as a cash cow. Examined as purely financial entities, many Fortune 500 companies are worth more dead than alive; they should be auctioned off, "down-sized" and dismantled for committing the sins of incompetence, inefficiency and, worse (until recently), low stock prices.

With a green light from the Reagan Administration, the restructuring craze of megamergers, takeovers, "down-sizing" and other financial stunts has become more and more frenzied, causing dramatic jumps in stock prices and creating the temptations that have been the undoing of those insider traders now pleading guilty in Federal courts.

The victims of the current scandal are not simply the outraged shareholders, institutional investors and other traders left out in the cold by the insider traders. A much greater loss is suffered by the one million or so managers fired or pushed into early retirement by companies that incur higher debt and other expenses while fending off hostile takeovers. This loss is made worse when arbitragers with illegal insider information accumulate a large block of a company's stock, pushing up the acquisition price or forcing the target company to pay a higher price to buy back its shares.

Shouldn't executives dismissed because of belt tightening sue for back pay?

Why shouldn't managers fired because of belt tightening in the aftermath of an illegal insider trading deal be allowed to file lawsuits for loss of income and back pay?

If you divide the one million managers fired or asked to retire early during the 1980's into the $300 billion siphoned off by corporations and their investment bankers during the same period for stock buy-backs and more acquisitions, you find that the "savings" from each case is $300,000 per manager. This is, of course, far more than they were paid. Even the most experienced and senior managers could very likely have been retained for far less.

And how have the corporations invested the fired managers' salaries to become more efficient and competitive? They have taken on a staggering level of new debt. Large corporations have diverted more than $300 billion since 1980 to repurchase their own stock or acquire other companies. This is a mind-boggling sum for insurance against being taken over and dismantled. On a different New York street, it would more easily be called "protection" money.

Executives have raided their own companies' treasuries following the advice of wealthy investment bankers, who charged them enormous fees and who, it now appears, then sold the inside information to become even wealthier.

While Wall Street loudly applauds cost-cutting moves, such as firing productive employees, it puts the same "restructured" companies into dangerously high levels of debt, forces a monomaniacal preoccupation with short-term earnings and promotes asset sales and layoffs rather than growth, innovation, reinvestment of earnings and research and development.

Even before Martin A. Siegel admitted passing along information that probably made Unocal Corporation's restructuring more expensive, the company's chairman, Fred L. Hartley, said: "Every day we open the door, we spend $2 million for interest. Think what that would have done for the U.S. if it had been put into job creation." Unocal's added debt load of $4 billion to repurchase stock and to avoid being taken over undoubtedly cost jobs at that company.

All this raises more serious questions about the reasoning so often heard on Wall Street that praises restructured corporations for cutting costs by shattering careers and laying off many of their long-service employees. It looks increasingly as if companies have merely transferred their savings from layoffs to professional investors and arbitragers.

The lesson to remaining employees is clear: place less trust in the company. Wall Street's advice to managers searching for excellence has been to tell them to become excellent at searching for new jobs.

The insider trading scandal will not put a stop to this continuing disfranchisement of the managerial class. As Peter F. Drucker, a management expert, noted recently, a drop-off in the pace of hostile takeovers will only increase pressures from institutional investors on corporate executives to find new ways to raise their companies' share prices. To meet this demand, they will have to pay even more attention to short-term results, take fewer risks and ignore the long-term consequences. Opportunities for younger managers to rise and be visible in such an environment will continue to diminish.

Many managers are already acting more like free agents in professional sports. This trend is about to accelerate. If a better job comes along, managers will take it. They are ready to leave quickly and they always return calls from headhunters. Since Wall Street supports lowered expectations for advancement and job security in big companies, smart managers are arranging ahead of time where they will go, at a moment's notice, if the ax falls on them or their company.

Loyalty was the first casualty of hostile takeovers. If you can't sue Ivan F. Boesky or Mr. Siegel for the loss of your job, at least you can start running in place to make sure your next job is a better one.

Paul M. Hirsch, professor of business at the University of Chicago, has written a book on surviving takeovers.

Senator **Hecht**. Mr. Chairman, may I follow your lead and say that we thank Mr. Howell's presence in the State of Nevada.

The **Chairman**. Yes, indeed.

Mr. **Howell**. Reno, NV, a great distribution center.

Senator **Hecht**. Thank you. I didn't hear you.

Mr. **Howell**. Reno, NV, a great distribution center. [Laughter.]

The **Chairman**. Very good. Well, thank you, Senator Hecht, and Mr. Howell both.

Our final witness is William McKinley, chairman and CEO of Gerber Products of Fremont, MI.

STATEMENT OF WILLIAM McKINLEY, CHAIRMAN AND CEO, GERBER PRODUCTS, FREMONT, MI

Mr. **McKinley**. Thank you, Mr. Chairman.

Our company is best known as the baby food company, but I do want to point out that we are very large in manufacturing and distributing and selling many lines in the apparel and juvenile furniture, as well as trucking and others.

I point out in my testimony some of those States in which we have our employees and certainly Wisconsin and Michigan are large in our numbers.

The **Chairman**. How about Nevada?

Mr. **McKinley**. We have employees in Nevada. I can't say that they're large, but they're there.

So we are very broad-based. We have employees in 49 States.

In the last 11 years, our company has been subject to a hostile takeover attempt. We made 11 friendly acquisitions and have been subject to numerous Wall Street rumored takeovers.

The company firmly believes that the current wave of hostile activity against the U.S. corporations does in most instances great disadvantage to this economy. I think when we became a debtor economy rather than an equity economy, we put ourselves in the position to be very, very disadvantageous in our international trade.

Our company believes it should invest for the long term and we should manage for the long term. It's very interesting to me that almost every analyst who ranks our company who uses a rating system will rank us say No. 2 in long-term investment ability, No. 2 being the second best.

On short term, because of all the problems we had last year, we are normally rated on a 4. But on a long term, as long as we can stay independent, they believe we're going to be a very successful company.

BOTTOM LINE IS WE ARE A TAKEOVER TARGET

The thing that hurts us at the bottom line is at the end of every analyst's report it also says, "They're a great takeover target."

We believe, rather than some of the other things that have been talked about here today, that what we really want is a more level playing field under the Williams Act. What we are asking for is, No. 1, a better timeframe for everyone to be able to make their presentations as to the facts and figures and truthful reporting by those who want to take us over.

We really don't believe that sweeping the streets should be a permissible activity.

We would also agree that greenmail should be eliminated as long as it's well defined. There may be instances in which a company should buy a large block of stock. I would hate to see that outlawed by an ill-defined greenmail situation.

When we have a debt economy, as we have today, then obviously people are going to start managing for the short term. We are not going to do the research that we need to be competitive in this international market. We're not going to invest in the new capital which should be invested in to make this country a real force.

I believe that these simple changes which would give us more time would be the thing that would be best done now and should be done today. I do not believe that we should attempt at this particular time to get into the actions as to what may be necessary on the junk bond issue and they are junk bonds regardless, but we should not get involved in the junk bond issue because I think at this point it's a long term situation and that answer requires a lot of thinking. I don't really want somebody in Washington DC deciding whether this is a good or a bad situation for our economy. I think the economy has to do it, but I think you have got to give us a level playing field to play on.

Thank you.

[The complete prepared statement of William L. McKinley follows:]

Gerber Products Company is a Michigan Corporation with its headquarters in Fremont, Michigan. While best known for its baby food, it is involved in manufacturing, distributing and selling a broad line of apparel and juvenile furniture under various trademarks. In addition, it has a trucking subsidiary, children centers in various states, a life insurance company and a small full service printing company. Our sales for this year will be approximately $1 billion.

Gerber has employees in all states except Alaska. Our largest number of employees reside in North Carolina followed by Michigan, Tennessee and Ohio, all of which have well over 1,000 employees. Wisconsin, Pennsylvania, Illinois, California, Arkansas, Arizona, Virginia, South Carolina and Alabama all have over 600 employees, thus, we are broad based in the United States.

In the past eleven years, we have been subject to a hostile takeover attempt, have made eleven friendly acquisitions, and have been subjected to numerous Wall Street rumored "takeovers."

The company firmly believes that the current wave of hostile activities against United States corporations does in most instances create great disadvantages, not only to the entire economy as it affects the ability to compete, but also to many stockholders, company employees, company programs for growth, the communities in which companies operate and suppliers.

Certainly the latest example of misuse of power have justified your committee's reason for this hearing. However, we are concerned, as we know you are, for those who demand over-reacting.

We believe:

1. That the substantial debt requirements often resulting from hostile takeovers or takeover attempts, are detrimental to long term capital investment and long term research expenditures that should be made in many of our industries. Failure to make such investment may and often has resulted in lack of international competitiveness.

2. That in general its successful companies that become victims of such hostile movements and the only result can be restructuring of the company, whether that is or is not in the best long term interest of the company, its employees or communities, or in fact, the total economy.

TESTIMONY OF FORMER WITNESSES

The **Chairman**. Thank you very much, Mr. McKinley.

Mr. Clark, I'd like to ask you about comments from Michael Bradley a witness that we had almost exactly 2 years ago who testified before this committee and argued that takeovers have been very beneficial for stockholders and they made this case. Michael Bradley is a professor at the Graduate School of Business at the University of Michigan at Ann Arbor, a brilliant man and a fine professor.

He said:

> The rate of return in dollar amounts—and we see that the 183 New York and American Stock Exchange firms involved in tender offers during this period of several years—target stockholders realized $5 billion net increase in net worth; acquirers $1 billion. The combined reevaluation of these assets is on the order of $6 billion.

Then he goes on to say:

> I've updated the data with the help again of the Securities and Exchange Commission, the Office of the Chief Economist. Here we look at the premiums paid to 136 targets in two-tier offers from 1981–84. Again we see huge economic gains to the targets. The targets here realized a total increase in value. This increase above the P announcement level of $35 billion.

Now that's one side of it. The other side is has been offered by two scholars, one at Columbia University, Professor Lowenstein, who made a study of several thousand takeovers over a period of 6 years, and he found that during that period that it was not the less efficient firms that are taken over but the more efficient. He found that the firms taken over had a 16-percent return on equity compared to an average return during that period of about 12 percent on equity.

And then there's another study by Professor Scherer of Swarthmore, a study of well over 1,000 mergers. He found no significant change in earnings from firms that were taken over in the first several years and then a deterioration after a short initial period.

Now it seems to me that what we have here is, on the one hand, people saying that when you have mergers that stockholders gain a capital increase, an increase in the capital value of their stock.

On the other hand, you have a situation in which the firm probably won't make more money; they may make less, and they have less competent management.

So that I think that both sides are right in the sense that the stockholders gain, sure; but the firms do not.

Do you have any observations on that, sir?

Mr. **Clark**. Yes, I do, Senator. First of all, one basis for the free market opinion is an article that appeared in 1981. I have great difficulty with some of the academic people, including, I think you said Professor Bradley, did you not?

The **Chairman**. Yes, sir.

Mr. **Clark**. Because part of this article suggests that even though management might be able to actively negotiate on behalf of their shareholders, that management should remain passive because the money is coming out of the pocket of the other shareholders and, in total, the value remains the same.

Now when the academic community puts forth that type of an analysis and basis for passivity on the part of management, I have to question whether they know much about the real market and the real world.

The Chairman. Well, how do you answer the argument that the value of the stock overall has gone up, in this case, by $35 billion over a period of 3 years?

LONG-TERM VIEW

Mr. Clark. It goes back to an earlier comment I made, Senator, and that is the value for control of a corporation should exceed the current market value of 100 shares which is being traded. If one is willing to sell the corporation—any corporation could put themselves up for sale tomorrow—they should demand a premium over the current market price.

The whole question that comes into play is, what is the long-term value? Should we put every corporation in America up for sale tomorrow, which I suggest to you would increase value to shareholders, or should we take the long-term view?

My corporation was subject to a possible takeover back in 1984. We instituted the right plan, more critically referred to as the poison pill. Since putting that into place, which I think protected us from a hostile takeover, we have appreciated against our stock price then about 120 percent. And this is against an S&P performance of something less than 90 percent.

I believe my shareholders are much better off today having not been taken over. I can create instant wealth tomorrow by putting the company up for sale, but isn't it the long-term view that we should be taking here?

The Chairman. Very good.

Mr. Howell, in 1985 when we had hearings on corporate takeovers, the Reagan administration urged us not to make any changes in our takeover laws. He said:

> Attention has been drawn to four drawbacks on takeovers. First, the corporate management time drain that is spent on fighting these takeovers; second, excessive corporate debt that is generated as a result of the takeovers; third, inadequate long-term investment; and fourth, job losses and community disruption.

Much of the testimony today cites those same drawbacks about hostile takeovers.

But the Reagan administration witness dismissed those concerns. He said:

> That such concerns are rooted in the desire by management to preserve the status quo and existing corporate structure.

And he goes on to say:

> Our review convinced us that these allegations are not really supported by the facts.

Now this administration has been criticized for many things, but it's not been known as antibusiness. It's strongly probusiness.

How then do you account for this almost disdainful dismissal of the concerns you gentlemen are voicing about hostile takeovers?

Mr. Howell. I can't respond on behalf of the administration, Mr. Chairman. I can tell you that from this side of the table it's been a frustrating experience to see that position taken.

I think what we have been trying to say this morning and what I specifically tried to say in my expanded testimony is—and I'm without benefit of ever having seen a business plan on the part of a firm or individual that makes the decision to launch a hostile takeover—but I would suggest to you that it's probably entitled "Takeover and Divest," rather than "Takeover and Manage."

The one side of the equation that all of us are responsible for is the managing of these enterprises. We are stewards for a certain period of time for publicly held companies. I think we are very concerned about what we sense and feel instinctively about what's gone on in the marketplace in terms of the appropriate focus. I think there's a different interpretation perhaps on the part of the administration in terms of whether this short-term focus is in the best interest of our country. In my judgment, the short term will jeopardize the future and that's what I'm concerned about.

The CHAIRMAN. Thank you.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you. Gentlemen, I apologize that I had to step out for a few minutes and if anybody has covered the same ground bear with me.

A lot has been made of the fact—certainly by our first panel and I suspect by you—that more or less underfinanced but sufficiently credible quick buck artists can come along and put almost any company in play, with the result that the company is going to end up being acquired by somebody somehow some way.

And there are two assumptions that underly what I have just said and what many of our witnesses have said. First, once a company is in play, there's going to be a profit made by the play maker and the arbs. Second, that that acquirer, whether he's white knight or not so white knight, will come along and end up with the merchandise.

SHAREHOLDER'S POSITION

Now my question to you is this. If the average shareholder is really just going along for the ride here—maybe that's a big if, but grant it—and ends up with the highest possible dollar price for what was a lower and often substantially lower price stock, what's wrong with that, Mr. Clark?

Mr. CLARK. I believe there are two things wrong with that, Senator.

First of all, under the current rules, the raider can accumulate a substantial number of shares and pay the market value without paying any premium for control. So that is denying substantial value to a large number of shareholders.

Second, are we really in the business of selling companies each and every day?

Senator HEINZ. Well, you're saying that the first 5 or 6 or 7 percent of shareholders who sell to him are denied.

Mr. CLARK. Are denied value.

Senator HEINZ. And I'll grant you that. But let's look at the other 80 to 95 percent who may not be. That was a key assumption I wanted you to build into any answer.

Mr. CLARK. OK. Fine.

Senator HEINZ. It may not be a valid assumption, but I'd like to give you that toughest case to address.

Mr. CLARK. As long as we agree that the first layer that's taken out is not given a premium for control.

Senator HEINZ. We understand that.

Mr. CLARK. And they are being disadvantaged.

Senator HEINZ. Sure.

Mr. CLARK. Another point is whether we in management can effectively control our corporations and manage them with the threat of a constant turnover? There are also other constituencies that must be considered. This all becomes a very difficult issue for managers to get hold of. As I said earlier, if we put our companies up for play tomorrow we could increase value for the shareholders immediately, but what about the other constituencies? If I go back to my illustration in my own company's case, I believe we can build greater value for all who are willing to stay with us over an extended period of time and I believe that's where my emphasis should be—not for the short term because of the dislocation and the negative impact on the other constituencies. In doing so I don't think we are denying value to our shareholders. It's just a question, do you want to get paid a quick buck today or do you want to be in for a longer period of time and prosper more meaningfully? That's the challenge.

Senator HEINZ. Bill Proxmire and I, although we try and inadvertently obscure it from time to time, both graduated from a place called the Harvard Business School in Cambridge, MA, where in course after course, year after year, we were taught that there was one thing that matters——

The CHAIRMAN. Include Don Riegle, too. All three of us.

Senator HEINZ. Well, he did kind of advanced studies there. He didn't have to serve in the Marine Corps there like we did. He kind of did that elsewhere and then got the gravy, but Don was a distinguished fellow or research candidate there.

In any event, the three of us were there and we were taught that what you want to do is maximize the value to the shareholder. Was the Harvard Business School wrong?

SHORT-TERM VERSUS LONG-TERM MAXIMIZATION

Mr. CLARK. No. I think the difference here, Senator, is are we talking about a short-term maximization or a long-term maximization? It's a period of time.

Senator HEINZ. They didn't make that distinction.

Mr. CLARK. No, I know they don't. I think it's in error. If I can show to you an example where you are foregoing a 20- or a 30-percent premium today in relationship to a compounded annual growth of say 20 or 30 percent over the years, aren't you better to stay with the situation?

Senator HEINZ. If asked, here is what they would have said, because I taught business administration. They would have said:

> You want the largest possible stock price as soon as you can so that you can redeploy the money that you have earned from that stock price into the next most attractive investment opportunity.

None of us were smart enough then to know that that was a question we should have asked, but that is what they would have said.

Now what is wrong with that answer?

Mr. CLARK. That's a valid point of view. I'm not going to argue with it. But here again, I think they are isolated—in only considering immediate shareholder value.

Senator HEINZ. Remember, Senator Proxmire, Don Riegle and I are here right now and there are 90 people in 10 different classrooms getting ready to graduate. Some of them are going to go to Wall Street. And they'd better get the facts straight and this is your opportunity via Wall Street to give them some wisdom or enhance moral direction. Don't fudge the question. Not that you are, but just take advantage of your opportunity is the polite way of saying that.

Mr. CLARK. Thank you for the opportunity. As I said, that is a valid point of view in maximization of shareholder value in the short term.

All I suggest to you is that it's another example where those in the academic world are ignoring the reality of how difficult it is to manage a company in that type of an environment.

I can assure you, Senator, that when a company is put into play or is suspect of being put into play there is great difficulty in retaining employees, in hiring new employees, in creating long-term relationships with vendors and suppliers. It's just difficult for management to manage in today's environment with that type of emphasis.

Senator HEINZ. Well, my time has expired.

Mr. FRIST. Mr. Chairman, might I dovetail onto that?

The CHAIRMAN. Go right ahead.

Mr. FRIST. I would like to suggest that the definition of shareholder be expanded to include, in the case of my company and most of corporate America, the shareholder that is the debt shareholder.

I don't agree that all shareholders participate equally in a hostile takeover where there's high leverage. In our case, we're 50 percent long-term debt financed. We sold $200 million worth of 30-year sound grade A bonds 2 days ago. If those bonds are put at jeopardy by a hostile takeover, almost equal to the increased value of a stock shareholder, the debt shareholder's value decreases and they should not be ignored. They're making a long-term commitment. The stock side of the equation is very short-term oriented.

Senator HEINZ. Mr. Chairman, I would like to make one suggestion since three of the four of us are HBS'ers—drop the H——

[Laughter.]

And that is, maybe we should get some of our former professors down here in the course of these hearings.

Senator RIEGLE. Good idea.

The CHAIRMAN. Very good.

Senator HEINZ. And see how they would answer the question today. Thank you.

The CHAIRMAN. We'll come to Mr. Baker in a minute but I've held up Senator Riegle for quite a while.

Senator RIEGLE. Well, Mr. Baker, if you had a comment you wanted to make, go ahead.

Mr. **Baker**. Well, being a Harvard Business School alumni, I read the bulletin last month and one of their faculty members made this statement, and I quote:

> There's not one hostile acquisition that is based on the kind of analysis we teach in business schools. The hostile acquirer doesn't know what's behind the balance sheet. He doesn't know what causes the income statement to be the way it is, and 10-Q's and annual reports are not reliable for this purpose.

We've all been directors. We know the problems inside the corporation. The hostile acquirer never knows them. He merely is measuring what can be financially driven for his own personal benefits.

I think the point of that is that he is not trying to maximize shareholder value. He's trying to make a quick buck. He's putting a lot of capital at risk and they don't always win, but by using the system they win often enough to make a very, very handsome return.

The **Chairman**. Thank you.

Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

Not that it's greatly important but just for the record to be accurate, I earned my MBA at Michigan State University and then went on to the Harvard Business School for doctoral work and spent 2 years there and had everything done but the thesis when the chance arose to run for Congress. That was 21 years ago. I got elected and did not go back to finish that work.

The **Chairman**. You're still working on your dissertation?

Senator **Riegle**. Well, not exactly. I feel like I'm working on my dissertation here today, let me tell you. These are the issues that we need to focus on.

URGENCY OF CHANGES REAL

I'd like to ask each of you a question that I put to the first panel and that is, am I to understand what you're saying here in terms of the changes that you feel need to be made that this is an urgent matter that you want to see the Congress act this year on the suggestions that you're making and that there's some risk to the economic system if we don't?

Is that a fair summary? And if it is, I'd like you to each say so.

Mr. **Baker**. I think everybody who participates in any kind of an action should be responsible and I think some participants are not responsible and I think we should build a few more rules into the system that protects us in that way.

Senator **Riegle**. And you want it done this year I take it? You're saying there's some sense of urgency here?

Mr. **Baker**. Yes, sir.

Senator **Riegle**. Is that a view that's shared by all of you? Mr. Clark, do you share that view?

Mr. **Clark**. Yes. I would underscore that. I think the very fact that we are here today talking to you underlines the urgency.

May I also emphasize that we're here asking for assistance because I don't believe we're going to get it out from the SEC or the administration.

In 1983, the SEC had a blue ribbon panel and one of the suggestions of that panel was that they change and close the 10-day

STATEMENT BY

WILLIAM L. McKINLEY

BEFORE THE

SENATE BANKING COMMITTEE

MARCH 4, 1987

AT HEARINGS ON

THE GENERAL SUBJECT OF THE NEED FOR REFORM OF THE PROCEDURES, PRACTICES AND FINANCING OF HOSTILE TAKEOVERS, AND THE EFFECTS OF THESE ACTIVITIES ON THE ECONOMY, PRODUCTIVITY, AND INTERNATIONAL COMPETITIVENESS.

3. That the company suffers during the period of an actual, threatened or rumored takeover from less effective work habits by all employees, from difficulty in hiring new employees and the managements inability to concentrate fully on the future well being of the company. All of these factors have in fact to some degree happened within our company at various times.

4. Two of our five principal suppliers of packaging material have announced major changes in their structure through takeovers. We are naturally concerned about the quality and dedication to the the future of the segment of their business we employ. While we have no reason to doubt their intent to provide the same quality and service, it naturally follows that this may not be possible.

5. In our own case, the hostile attempt was some ten years ago. The net result to stockholders by holding their stock in our company is greater than both the Standard & Poor's industrial and Dow Jones index gains during that period. This was in spite of a relatively poor performance this past year due to other circumstances.

As to suggested changes, we believe they shall be moderate but should improve the "playing field." We believe the stockholders should be given every opportunity to make a clear decision without fear of losing out if they delay. Thus for a hostile tender offer, the rules should provide that:

1. To avoid the creeping tender offer upon reaching 5%, notice should be within 24 hours.

2. Any withdrawal of a tender offer should result in the inability to acquire shares for some extended period (e.g., at least six months).

3. Prior to the making the offer, financing must be in place and the offer must provide for:

   a. Purchasing all shares at a single price.
   b. Purchasing for cash.

If the shares are purchased "for investment" there should be a time limit after such statement is rescinded before a tender offer can be made.

window. There's a recommendation from a blue ribbon panel and this was 1983 and absolutely nothing has been done. So that's why we're here today.

Senator **RIEGLE**. Mr. Frist, do you want us to act this year?

Mr. **FRIST**. Subtle changes and refinements of the Williams Act to level the playing field.

Senator **RIEGLE**. Mr. Howell, is that your view as well?

Mr. **HOWELL**. Urgency is the word.

Senator **RIEGLE**. Mr. McKinley?

Mr. **MCKINLEY**. Yes, on the Williams Act aspect of it.

Might I also just make one quick comment regarding the Williams Act? The reason we are here asking for help is that when you passed the Williams Act or when it was passed so many years ago, you took from the States, according to the Supreme Court, the right to do those things which they formerly did for us. That's one of the reasons we are here.

Senator **RIEGLE**. Yes; you know, have you all taken these same concerns to the administration—I mean, to the officers in charge of carrying out the law today to ask for changes? If so, have you been able to get in the door? Have you gotten the brushoff or what's happened?

I'm surprised that when as a prestigious a group of witnesses, whether it's this panel or the first panel, it's surprising that either you have not approached the administration or been able to get a response from the administration. Have your tried?

Mr. **FRIST**. Now that we have such an outstanding new face from the State of Tennessee in the administration, I think we may try again.

Senator **RIEGLE**. You have a new door to knock on?

Mr. **FRIST**. Yes.

Senator **RIEGLE**. You think he may be a little more sympathetic than Don Regan to the issues you are raising?

Mr. **FRIST**. What do you think, Senator Sasser? [Laughter.]

Senator **SASSER**. Dr. Frist, we ask the questions here. [Laughter.]

Senator **RIEGLE**. I'd like to ask one other thing and that is—I gather you feel that now the change in the lineup may give you a little better opportunity to go and present your case. Is that what you're really saying?

Mr. **FRIST**. Yes, sir.

Senator **RIEGLE**. Well, maybe that will be the case. I guess we'll find out in short order.

I'd like to ask each one of you what you think the single worst abuse is that's taking place with hostile takeovers as you see them in terms of the single most important thing for us to change? If that turns out to be two things, then fine; but can you put at the top of the list the thing that you think is the worst single practice that needs to be changed here?

Mr. **BAKER**. I think in today's world of telecommunications and instant electronic communications, it's a real crime not to require those people accumulating stock to report that every day.

Senator **RIEGLE**. So it's the secrecy, the concealment, when market action is underway and the fact that for that period of time that secret knowledge has a value and people can use it and they can use it improperly and to the disadvantage of others?

Mr. **Baker**. That's right.

Senator **Riegle**. Mr. Clark, what would you indicate.

Mr. **Clark**. You gave me two choices. My first would be to close the 10-day window and require immediate disclosure when you get up to 1 percent.

Senator **Riegle**. One percent?

Mr. **Clark**. And then wait 10 days before you are allowed to buy any additional shares.

The second is to extend the tender offer period from 20 to 90 days because during that period of 90 days management can call a shareholders' meeting and ask the shareholders what they want. Management can also explore other alternatives. I've always said that if the shareholders want me to liquidate the company, I'll do it for them and save those horrendous fees that go to Wall Street. If they want to liquidate, let management do it under the direction of the shareholders. But give me 90 days to convince the shareholders of what action we should take.

Senator **Riegle**. Mr. Frist?

Mr. **Frist**. No additional comments.

Senator **Riegle**. Mr. Howell, you would concur with what's been said?

Mr. **Howell**. I would agree.

Senator **Riegle**. Mr. McKinley?

Mr. **McKinley**. I would agree 100 percent.

Senator **Riegle**. All right. Thank you. My time is up. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Riegle.

Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

QUESTION OF A POSSIBLE CONNECTION BETWEEN HOSTILE TAKEOVERS AND INSIDER TRADING

Gentlemen, the question was asked obliquely of the previous panel and then we moved on without a response because they were confronted with a second question. But an inference was made as to whether or not the first panel considered there to be a relationship between insider trading and merger mania, and I gathered by at least the body language of a couple of the former panelists that they thought there might be some connection and I wanted to ask this panel. Do you see any connection between insider trading and the separate problems that are raised by hostile takeovers, or is there, in your view, a connection between these two?

Mr. **Baker**. Senator, I would respond that any time there is a potential to make 35 percent almost overnight in the stock price of a company that has been put into play, there is a great temptation for insider information and insider trading. I think it goes on every day. I think it's promulgated by this hostile takeover game.

Mr. **Clark**. I think we've only seen the surface of the illegality in the insider trading that has taken place. I would recall that one of our Chicago-based companies, the Staley Co., is bringing charges against Drexel-Burnham for parking stock, accumulating shares, without disclosure, and then threatening to put the company into play unless they agreed with the demands of Drexel-Burnham to a leveraged buyout.

Mr. **Frist**. Insider trading frequently connotates management. I don't think it's a problem within corporate America of insider trading. I think the definition of insider trading, if it extends out into the investment community, there are problems there that need to be clearly defined and addressed.

Mr. **Howell**. With the revelations being beyond anything we had anticipated—I think any of us in this room—it's hard not to associate the two subjects, Senator. I obviously don't have any further knowledge than what I read in the newspaper on the subject of insider trading, the abuses. I attended the University of Oklahoma, where unlike Harvard, we spent probably more time on the football field than we should have, but we concentrated on rightness, wrongness, and the simplicity of life. And I remember a professor that shared with us one day the idea that the temptation does increase with the dollars involved. And that was 30 years ago. I think what Jim Baker tried to say to us about our young people—if the hostile takeover game is beginning to attract some of our best talent out of some of our best educational institutions, it should be of concern to all of us and I think it is. We have businesses to run and businesses to manage.

Mr. **McKinley**. I would just say that I think sweeping the streets is a good example of where those two connect.

Senator **Sasser**. Well, Mr. McKinley, you touched on something a moment ago that has been a great concern to me for some time. There are many economists who will make a good case that one of the problems in our American economy is too many of our corporate managers are focusing on short-term results as opposed to long-term planning and long-term results. And you indicated that with the Gerber Co. one of your strong suits is the fact that you focus on long-term results and that this might make you more susceptible to a hostile takeover.

Do you have any recommendations as to what could be done to encourage corporate America to focus more on long-term results and what could be done to alleviate the exposure of a hostile takeover?

Mr. **McKinley**. I think that's a very all-inclusive type program that needs to be looked at as to what can be done. I really don't want the Government to try to help me on short-term and long-term, except I would like to have the opportunity to have time to explain my position to stockholders and others. That's the kind of thing we're talking about here. Give us time through the Williams Act to respond and to get to those people.

Senator **Sasser**. I suppose my real question is this. Don't hostile takeovers force corporate managers to focus more on short-term results, short-term profits, as opposed to long-range planning that might be in the best interest of their company in the long range and certainly in the best interest of the American economy long range by making us more competitive?

Mr. **McKinley**. You have to overcome all the pressures on you to cut research, the pressures to cut advertising, the pressures to cut new investment. But if you're going to manage it, you've got to do that. But those pressures are there because of the pressures that can be put on us for takeover.

Senator SASSER. Does anybody else want to comment on that?

Mr. BAKER. One possibility, Senator, is to charge an excessive tax for very short-term profit swings in stock trading. That might have some benefit.

Mr. CLARK. I would recommend that as something which needs further study but if we had a system where you needed to be a shareholder for 6 months or 1 year before you could vote on tender offers or a merger, this would help management emphasize long-term results.

Right now, a speculator who buys the stock today has as much power and say in the direction of the corporation as someone who's been in there for the long pull.

I had the example in my written material that it perhaps is akin to a group of people moving across a State line and voting in a senatorial race and then having done their damage going home.

DEGREE OF FOCUS

Mr. HOWELL. Senator, I would just make a comment. I think any time we read about someone who analyzed a company or companies and comes up with a ranking of the best-managed companies in our country, they always link short term and long term. I think they are inseparable.

What I'm concerned about is the degree of focus. You've got to have some short-term focus in today's business, but it must be in concert with a longer strategy to assure growth and continuity in the long term.

The CHAIRMAN. I'm not sure I understood that. You say that you can have a well-managed concern with a focus on short term?

Mr. HOWELL. They are inseparable in my mind, Mr. Chairman—the long term and the short term in terms of managing the business. Obviously, you are not going to get to the long term implementation and the strategies that you have in your 5-year or 10-year plan unless the business is healthy in the short term.

We just came off the best year in the history of a company that's 85 years old and that bodes well for moving forward into added investments into the future. So the business must be healthy in the short run in order to be healthy in the long term.

The CHAIRMAN. That's very, very interesting because I haven't heard it put quite that way and I think that's very helpful. At the same time, if you look at it the other way, there's a terrific temptation. You can always maximize things in the short term and there's great pressure to do it—the next quarter results. On the other hand, it's the long term that I think you fellows get paid to really look at and should be looking at.

Any further questions?

Senator SASSER. Well, Mr. Chairman, I would just say this. I think that Dr. Frist in his testimony hit the nail on the head when he spoke of stakeholders, because there's more at stake here than just shareholders. You've got consumers, suppliers, workers, holders of pension obligations, and then I think the economy at large has a big stake in this.

The Chairman. It sure has these days with the competitiveness problem we have.

Senator Sasser. Indeed. Thank you.

The Chairman. Thank you very, very much.

Thank you, gentlemen, for excellent testimony.

Our final panel is Robert Luciano, chairman and CEO of Schering-Plough; Robert Mercer, chairman and CEO of Goodyear Tire & Rubber; Alvah Chapman, chairman and CEO of Knight-Ridder; William Smithburg, chairman and CEO of Quaker Oats; William Wall, chairman and CEO of Kansas Power & Light; and Clarence Johnson, chairman and CEO of Borg-Warner.

Senator Sasser. Mr. Chairman, with your permission, Mr. Chairman, I would like to take this occasion and opportunity to introduce and welcome Mr. Robert Luciano to this hearing this morning.

He is the chairman and CEO of Schering-Plough Corp. and that is a most valued corporate citizen of my State. I might say, Mr. Chairman, that a large part of Schering-Plough was started decades ago by a man by the name of Abe Plough who started manufacturing pharmaceuticals in his basement. Now Schering-Plough is a large worldwide corporation and I am confident that we will benefit this morning from Mr. Luciano's testimony. He has had some considerable experience with the whole issue of corporate takeovers, some of which I judge has been not too pleasant.

So we welcome you here this morning, Mr. Luciano.

The Chairman. Thank you very much. I might say that Mr. Alvah Chapman, who's the chairman and CEO of Knight-Ridder is on his way. I understand his plane has landed. He gave a speech this morning in Chicago and all of us who are in politics know what that is. He's coming in. We expect him shortly, but we will go right ahead.

Mr. Luciano, why don't you start off.

STATEMENT OF ROBERT P. LUCIANO, CHAIRMAN AND CEO, SCHERING-PLOUGH CORP.

Mr. Luciano. Thank you, Mr. Chairman, and thank you, Senator Sasser, for those kind words about our company.

I do welcome this opportunity to appear before the committee to discuss the effects of the current takeover environment on American business in general and on the pharmaceutical industry in particular. You have copies of my testimony for the record and I won't go into it in any detail.

The Chairman. Without objection, that will be printed in full in the record.

Mr. Luciano. Thank you, sir.

In deference to the hour, I will just make three points in summary that I tried to make in that testimony.

CONSEQUENCES OF TAKEOVERS

First, I wanted to express my concern about the consequences of bust-up takeovers on the employees and the communities of the target companies. Within the last 10 days, for example, the New York Times reported that, as a consequence of an aborted takeover bid for Owens-Corning Fiberglass Corp., that company was undertaking a restructuring to repay the $2.6 billion in debt which it had incurred to fend off that raider. The result, in part, was the closing of a profitable plant in Barrington, NJ, my home State, with the loss of 800 jobs and the closing of a second plant in Jackson, TN, another State with which, as Senator Sasser indicated, my company has strong contacts.

Now I would suggest to you that it doesn't really matter to the affected communities or to the employees whether these so-called restructurings come about by reason of the actions of the target company to fight off an acquisition or by the raider to pay off his costs and to pocket his profit before he goes away. The results are precisely the same; namely, lost jobs and community disruption.

And I'm not expressing any judgment about the facts on that particular case because I really don't have the facts. What I am trying to stress is that the current state of the law which permits a company which has recently emerged from bankruptcy, as the raider was in that case, to mount a highly leveraged attack on another profitable company, as the target was in that case—that current state of the law which permits these things to happen is the proximate cause of those unfortunate events for the employees and for the communities in which they live. If you take actions to curb such abusive raids, you will also be curbing the consequences of those raids on the communities and the people being restructured.

Second, I wanted to add my voice to the observations made by people like Felix Rohatyn, Peter Drucker and John Kenneth Galbraith—I wanted to add my concern to theirs when they expressed their concerns about the increasing debt and the decreasing liquidity of corporate America. When the economic cycle moves to recession or to tight money conditions, as it inevitably has to at some point, the financial stability of the issuers and particularly the federally insured purchasers of some of that debt may well be called into question.

And once again, if you take action to regulate the genesis of that debt—namely, highly leveraged takeover financing—and I'm not talking here about financing for new plants, I'm not talking about financing to implement new ideas. I'm talking about takeover financing. And if you regulate the abuses associated with highly leveraged takeover financing, you're going to go a long way toward avoiding the potential consequences on the credit markets.

Finally, I wanted to make the point that in high tech industries—those that gain their competitive advantage from R&D—you require a long-term, stable investment pattern, both in research and in plant and equipment. Those investments in the short run do penalize earnings, but without such commitments research-based companies are destined to become also-rans, particularly to the European and the Japanese companies which are free to take the longer term view.

Research and development is the sine-qua-non for success in our business and any policy which discourages such long-term investments injures the global competitiveness of the American pharmaceutical industry and will eventually result in the export of technology and jobs.

Such a policy may also retard or prevent the development of new products to address the health needs of the American public.

Consequently, for all of the reasons which I have enumerated, I would suggest that the committee give serious consideration to the legislative proposals contained in my testimony and the measures advocated here this morning by the other witnesses who have appeared before you.

Thank you.

[The summary statement and the complete prepared statement of Robert P. Luciano follow:]

Summary - Mr. Luciano's testimony
before the Senate Banking Cmte. - 3/4/87

RPL/LM
3/2/87

Mr. Chairman and members of the Committee, my name is Robert P. Luciano and I am the Chairman and Chief Executive Officer of Schering-Plough Corporation. Schering-Plough is a worldwide company engaged in discovery, development, manufacturing and marketing of pharmaceuticals and consumer products. In 1986, we had sales of $2.4 billion, net income of $266 million and at year-end had total assets of over $3 billion. We employ 23,500 people and have major facilities in the states of New Jersey, Tennessee, Florida, California, Arkansas and Illinois.

I welcome this opportunity to appear before the Committee to discuss the effects of the current takeover environment on American business in general and the pharmaceutical industry in particular. You have copies of my complete testimony for the record. In summary, the points I wish to make are as follows:

First, I want to express my concern about the consequences of bust-up takeovers on the employees and communities of the target companies. Within the last ten days, the New York Times reported that, as a consequence of an aborted takeover bid for Owens-Corning Fiberglass Corporation, that company was undertaking a restructuring to repay the $2.6 billion in debt it had incurred to fend off the raider. The result, in part, was the closing of a profitable plant in Barrington, New Jersey, my home state, with the loss of

800 jobs and the closing of a second plant in Jackson, Tennessee, another state with which my company has close ties. It doesn't matter to the affected communities or the employees whether these so-called restructurings come about by reason of the actions of the target company to fight off an acquisition or of the raider to pay off the costs of the raid and pocket his profits -- the results are the same, lost jobs. I am not expressing any judgment on this particular case because I don't have all the facts, but I am saying that the current state of the law which permits companies recently emerged from bankruptcy, as the raider was in this case, to mount a highly leveraged attack on another profitable enterprise is the proximate cause of these unfortunate events for those employees and the communities in which they live. If you take action to curb such raids you will also curb their consequences on the people and the communities being "restructured."

Second, I want to add my voice to those observers -- Felix Rohatyn, Peter Drucker and John Kenneth Galbraith, to name just a few, who have recently expressed their concern about the increasing debt and decreasing liquidity of corporate America. When the economic cycle moves to recession, or tight money conditions, as it inevitably will at some point -- the financial stability of the issuers and the federally insured institutional purchasers of that debt may well be called into question. Once again, action to curb the genesis of this debt -- highly leveraged takeover financing -- will go a long way toward avoiding its consequences.

Finally, I wanted to make the point that high tech industries -- those that gain their competitive advantage from research and development -- require long-term, stable investment patterns in research, as well as plant and equipment. Those investments in the short run penalize earnings, but without such commitments research based companies are destined to become also rans, particularly to the European and Japanese companies which are free to take the longer term view. R&D is the sine-qua-non for success in my business, and any policy which discourages such long-term investment injures the global competitiveness of American pharmaceutical companies and will inevitably result in the export of technology and jobs. It may also retard or prevent the development of new products to address the health needs of the American public. Consequently, for all of the reasons I have enumerated, I suggest the Committee give serious consideration to the legislative proposals contained in my prepared testimony and the measures advocated here this morning by the other witnesses who have appeared before you.

Thank you.

# # #

Testimony of
Robert P. Luciano
Chairman and Chief Executive Officer
Schering-Plough Corporation

Mr. Chairman and members of the Committee, my name is Robert P. Luciano and I am the Chairman and Chief Executive Officer of Schering-Plough Corporation. Schering-Plough is a worldwide company engaged in the discovery, development, manufacturing and marketing of pharmaceuticals and consumer products. In 1986, we had sales of $2.4 billion, net income of $266 million and at year-end had total assets of over $3 billion. We employ 23,500 people and have major facilities in the states of New Jersey, Tennessee, Florida, California, Arkansas and Illinois.

I welcome this opportunity to appear before the Committee to discuss the effects of the current takeover environment on American business in general and the pharmaceutical industry in particular. In my opinion, this situation presents a clear threat not only to the economic health of many American corporations and our economy but, potentially, to the physical health of every American.

Successful innovation, the outcome of technological advancement, has been the hallmark of America's economic health and competitive strength. We are a nation of innovators -- inventors of mechanical and electronic devices; experimenters with test tube and microscope -- scientists, engineers, technicians working together, or alone, in laboratories or companies large and small.

Innovation requires a measure of genius -- a trait that in this country has never been in short supply. But genius alone is not enough. Innovation today requires substantial and sustained

INVESTMENT IN RESEARCH AND DEVELOPMENT -- TO PROVIDE OUR INNOVATORS WITH THE INCREASINGLY COSTLY TOOLS AND LABORATORIES -- AND ABOVE ALL, THE TIME -- TO ACHIEVE THE SCIENTIFIC AND TECHNOLOGICAL BREAKTHROUGHS ON WHICH THE HEALTH AND COMPETITIVENESS OF THESE INDUSTRIES DEPEND.

RESEARCH IS A LONG-TERM PROCESS, WHERE PROGRESS IS MEASURED IN FITS AND STARTS, FALSE STEPS, AND ONLY SOMETIMES BOLD LEAPS TO SUCCESS. THE PAYOFFS FOR THIS PROCESS CAN BE EXTRAORDINARY, WITH RETURNS THAT BENEFIT SOCIETY AND REWARD THE INVESTOR.

THE PHARMACEUTICAL INDUSTRY IS ON THE VERGE OF THE MOST DRAMATIC STEP IN ITS HISTORY -- THE GIANT LEAP FROM TREATMENT TO PREVENTION. BECAUSE WE HAVE CRACKED THE GENETIC CODE, WE CAN NOW DEVELOP PRODUCTS THAT MAY PROVIDE ACTUAL CURES FOR A WIDE RANGE OF DISEASES RATHER THAN MERELY RELIEVE THEIR SYMPTOMS.

RESEARCH AND DEVELOPMENT AND CAPITAL INVESTMENTS ARE THE DRIVING FORCE BEHIND SUCH ACHIEVEMENTS -- THEY ARE THE LIFEBLOOD OF OUR INDUSTRY AND OF MY COMPANY. OVER THE LAST FIVE YEARS SCHERING-PLOUGH HAS INVESTED $852 MILLION IN R&D AND $911 MILLION IN CAPITAL EXPENDITURES -- ALMOST ONE BILLION DOLLARS ON EACH ENDEAVOR. THESE INVESTMENTS FOR FUTURE PROFITABILITY, WHICH INITIALLY DEPRESSED OUR COMPANY EARNINGS, HAVE ONLY RECENTLY BEGUN TO PAY OFF. WE HAVE ALWAYS BELIEVED THAT OUR CORPORATE STRATEGY WAS SOUND FOR THE LONG-TERM INTERESTS OF OUR SHAREHOLDERS, EMPLOYEES, CUSTOMERS AND THE COMMUNITIES THAT WE SERVE. NOW THAT CONFIDENCE IS BEING VINDICATED BUT, IN THE SHORT RUN, IT PUT US AND OTHERS WHO HAVE A LONG-TERM OUTLOOK AT RISK TO CORPORATE BUST-UP ARTISTS.

THAT STRATEGY AND THE RESULTS IT HAS PRODUCED, BOTH FOR OUR SHAREHOLDERS AND FOR THE MEDICAL PROFESSION AND PATIENTS WE SERVE, AREN'T GOOD ENOUGH FOR SOME SO-CALLED "INVESTORS" -- THOSE WHO THREATEN TO DEMOLISH SOUND, SUCCESSFUL, WELL-MANAGED COMPANIES FOR THE SAKE OF INSTANT GRATIFICATION. THOSE RESULTS AREN'T GOOD ENOUGH BECAUSE THEY ARE NOT IMMEDIATE. THE CORPORATE BUST-UP ARTIST ISN'T CONTENT TO BENEFIT IN THE MEDIUM - OR LONG-TERM FROM HIS INVESTMENT IN A LARGE AND SUCCESSFUL COMPANY. HE WANTS TO BENEFIT NOW, TODAY, IN HIS POCKETBOOK. AND ANYTHING THAT MAY BE SAID TO THE CONTRARY NOTWITHSTANDING, HE DOESN'T CARE ABOUT THE WELL-BEING OF THE COMPANY AFTER HE'S THROUGH WITH IT -- OR ABOUT THE WELL-BEING OF THE CUSTOMERS AND OTHERS THAT THE COMPANY EXISTS TO SERVE.

THE PRIMARY OBJECTIVE OF THE JUNK-BOND BUST-UP TAKEOVER IS NOT TO OPERATE THE BUSINESS OF THE TARGET IN A MORE EFFICIENT MANNER, OR REPLACE AN INEPT MANAGEMENT, BUT, RATHER, TO MAKE EXTRAORDINARY SHORT-TERM PROFITS FOR THE TAKEOVER ENTREPRENEUR -- TO CAPITALIZE ON TEMPORAL DISPARITIES IN VALUE WHICH MAY OCCUR IN THE MARKET FROM TIME TO TIME. THE CURRENT TAKEOVER ATMOSPHERE, WHICH IS DOMINATED BY SUCH TRANSACTIONS, ENCOURAGES CORPORATIONS TO THINK DEFENSIVELY, TO MINIMIZE RESEARCH AND DEVELOPMENT EXPENDITURES WHICH AREN'T IMMEDIATELY PROFITABLE, AND TO MAXIMIZE PROFIT TODAY BECAUSE TOMORROW MAY NEVER COME.

THE UNPRECEDENTED GROWTH IN CORPORATE DEBT IN THE LAST FEW YEARS HAS BEEN IN PART A RESPONSE TO THIS TAKEOVER ENVIRONMENT. IN A RECENT THREE-YEAR PERIOD, CORPORATIONS HAVE BORROWED $483.4 BILLION, WHILE THEIR EQUITY FINANCING FELL $226.1

The CHAIRMAN. Thank you very much, Mr. Luciano.

Our next witness is Chairman Mercer of Goodyear Tire & Rubber. Mr. Mercer, go right ahead, sir.

STATEMENT OF ROBERT E. MERCER, CHAIRMAN AND CEO, GOODYEAR TIRE & RUBBER CO.

Mr. MERCER. Thank you, Mr. Chairman, and members of the committee.

I am Robert E. Mercer, chairman and CEO of the Goodyear Tire & Rubber Co., which last fall was the target of an attempted takeover and we welcome this opportunity to describe the impact of that attempt.

A more detailed testimony was submitted for the record and I respectfully ask, Mr. Chairman, that it be included.

FALLOUT FROM GOODYEAR TAKEOVER ATTEMPT

Goodyear resisted takeover in the best interest of the company and its real or long-term shareholders, our employees, and plant town communities, suppliers, creditors and, of course, our customers without whom there would be no business in which to invest.

In the accelerated restructuring required because of the takeover attempt, the corporation is becoming 12 percent smaller, three plants will be closed, employment reduced by 4,000 jobs, capital spending and R&D weighted toward projects with short-term payout, and we are assuming a $4 billion debt load which will leverage the company to an unprecedented 80 percent of debt to total capitalization.

In Cumberland, MD, one of the three communities in which we are closing plants, we will be able to maintain a subsidiary headquarters through help from all levels of government.

To those who say that takeovers are inherently good for America's competitive ability, let me offer some historical perspective from Goodyear's experience.

In 1977, at a time when the tire business was at a low ebb, we invested $260 million in a new state-of-the-art radial auto tire plant in Lawton, OK to assure our future competitive position in world markets.

With the same objective, during the 1970's and early 1980's, we modernized tire plants in Alabama and Tennessee and built a highly competitive wire plant in North Carolina to provide top quality steel wire for use in our tire products.

Then in 1983, we invested $250 million to convert a Texas bias tire plant to radial tires with costs that will meet Korean competition head-on when the startup phase is completed later this month.

Because of those investments, Goodyear's U.S. plants can hold their own today in global competition. In many foreign countries, for instance, it takes 25 to 50 man-minutes to manufacture a 13-inch tire. Our modern U.S. plants do it with less than 10. Our advanced technology and equipment make it possible to support higher American wages and benefits—more than $20 an hour versus as low as $1.60 in Korea.

Now had we been the target of a takeover attempt in the mid-1970's, had we been forced then into the short-term planning and investment now a way of life for American industry because of this takeover frenzy, none of those investments could have been made—at least not in this country.

Nor would we still be operating two general products plants in Ohio which were carried through some very lean years by long-term planning and now are doing a booming business and maintaining jobs.

Nor had our R&D in the past concentrated only on the short term could we be drawing now on a reservoir of advances and innovations that will keep our products competitive while we work our debt down to a normal level.

Only because Goodyear has been a well-managed company, as a number of outside observers have attested; because we had planned for the long term, were we able to survive the takeover attempt with a reasonably good prospect of maintaining and improving our competitive position in our tire and general products businesses.

Meanwhile, however, foreign competitors already are making investments we cannot match here in the United States and they must take great comfort in seeing our board and our management concentrate on debt service and debt reduction at the expense of investment in technology and product development.

Unless steps are taken to put hostile takeovers into the same framework of due process, time and scrutiny required when public companies approach mergers or acquisitions on an open, negotiated basis, short-term planning and investment will be the only course available to all of American industry.

While I am heartened by the attention being given to the issue by this committee and by the crackdown on insider trading on Wall Street, I want to say for the record, however, that I know of no link between insider trading activity and the attempted takeover of Goodyear. However, the SEC has not yet reported on its investigation of our ordeal.

It's comforting to see that the regulatory system does work. It is disturbing to see the level of abuse reached before the system kicks in. For that reason, I hope that Congress will move swiftly to level the walls of special privilege behind which raiders and speculators stalk their prey with their weapons of stealth and manipulation. Those walls of special privilege enable raiders and speculators to avoid laws, rules and regulations which public corporations must observe, to force movement in stock prices by what amounts to deception and coercion, to disregard obligations to the public good while slandering the abilities and motives of those who accept such obligations.

KEY TO HOSTILE TAKEOVERS

Now I don't pretend to know how to craft the careful legislation required to curb destructive takeovers while preserving the ability to make healthy, productive mergers and acquisitions. I do know that the key to hostile, destructive takeovers is made up of secrecy, stealth, and speed. To take hostility and unfairness out of the takeover scenario, more time and more information must be built into this process.

My suggestions would run along the lines of many of those that you have been hearing—earlier reporting to the SEC, closing the 13(d) filing window, extending the tender offer and so on.

Right now it looks to many people out there, including hundreds of thousands of smaller shareholders, that there's a lot of game-playing going on in the executive suites on Wall Street.

We need to return mergers and acquisitions to a system based on honest dealing, to return it to the basic meaning of the word securities as the currency of our financial world, and then American industry can get back to the job of improving its competitive position, producing goods and services and providing wealth for the whole economy and not just for the deal makers.

[The complete prepared statement of Robert E. Mercer follows:]

BILLION.1/ CORPORATE MANAGERS HAVE LEVERAGED THEIR BALANCE SHEETS IN THE HOPE OF RETAINING THE BENEFITS OF LEVERAGE FOR THEIR OWN SHAREHOLDERS, RATHER THAN ALLOW A RAIDER TO CAPTURE THIS GAIN.

AT THE SAME TIME, CORPORATIONS ARE REDUCING THEIR CASH AND SHORT-TERM INVESTMENTS TO MAKE THEMSELVES A LESS ATTRACTIVE TARGET. AS PETER F. DRUCKER HAS OBSERVED, IT IS "BECOMING DANGEROUS FOR ANY COMPANY TO BE LIQUID. LIQUIDITY CAN ONLY ATTRACT THE RAIDER WHO CAN EXPECT TO REPAY HIMSELF, AND THE DEBT HE INCURS IN BIDDING FOR THE COMPANY, OUT OF THE COMPANY'S CASH."2/

THE PERILOUS COMBINATION OF INCREASED LEVERAGE AND LIQUIDITY SHRINKAGE PORTENDS AN ECONOMIC CATASTROPHE. JOHN KENNETH GALBRAITH HAS RECENTLY WARNED:

> THE END FOR THOSE IN THE PRESENT PLAY WILL COME WHEN EITHER RECESSION OR A TIGHT-MONEY CRUNCH TO ARREST INFLATION MAKES THE DEBT LOAD THEY HAVE SO CONFIDENTLY CREATED NO LONGER TOLERABLE. THEN THERE WILL BE THREATS OF DEFAULT AND BANKRUPTCY, A DRASTIC CONTRACTION IN OPERATIONS, NO BONUSES, A TRIMMING OF PAY AND PAYROLLS, AND NUMEROUS VERY, VERY EARLY RETIREMENTS.3/

LAST MARCH I TESTIFIED BEFORE A NEW JERSEY STATE SENATE COMMITTEE THAT WAS CONSIDERING A BILL TO ADDRESS THE THREAT OF JUNK-BOND, BUST-UP TAKEOVERS OF NEW JERSEY COMPANIES. THE RESULTING LEGISLATION BECAME LAW LAST SUMMER AND PREVENTS A 10% SHAREHOLDER FROM EFFECTING A BUSINESS COMBINATION WITH A TARGET FOR FIVE YEARS UNLESS THE ACQUISITION IS APPROVED BY THE TARGET'S BOARD OF DIRECTORS PRIOR TO THE ACQUISITION OF SUCH A STAKE. THE ACT WILL EXPIRE ON JANUARY 23, 1988, UNDER A "SUNSET" PROVISION WHICH WAS INCLUDED AT THE LAST MINUTE. SCHERING-PLOUGH IS JOINING WITH THE NEW JERSEY BUSINESS AND INDUSTRY ASSOCIATION, THE NEW JERSEY CHAMBER OF COMMERCE AND THE NEW JERSEY AFL-CIO TO SECURE ITS PERMANENT REENACTMENT.

PIECEMEAL STEPS BY VARIOUS STATES IS NOT THE ANSWER, HOWEVER. CONGRESSIONAL ACTION IS NEEDED TO CURB THE EXCESSES OF TAKEOVER ENTREPRENEURS AND PERMIT CORPORATE MANAGEMENT TO RETURN

1/ CLARK AND MALABRE, "DEEP IN HOCK," THE WALL STREET JOURNAL, (FEBRUARY 2, 1987) P. 16.

2/ DRUCKER, THE FRONTIERS OF MANAGEMENT, (TRUMAN TALLEY BOOKS, 1986) P. 243.

3/ GALBRAITH, "THE 1929 PARALLEL," THE ATLANTIC MONTHLY, (JANUARY 1987) P.66.

ITS FOCUS TO LONG-TERM GROWTH AND COMPETITION IN THE GLOBAL MARKETPLACE. SPECIFICALLY, I RECOMMEND THE FOLLOWING MEASURES FOR YOUR CONSIDERATION:

- PROHIBIT A COMPANY FROM REPURCHASING ITS SHARES AT A PREMIUM OVER THE MARKET PRICE FROM A HOLDER OF OVER 5% OF ITS STOCK UNLESS SUCH ACTION IS APPROVED BY A MAJORITY OF STOCKHOLDERS, OR THE COMPANY MAKES A PRO RATA OFFER TO ALL OF ITS STOCKHOLDERS;
- REQUIRE THAT ACQUISITIONS OF OVER 10% OF A COMPANY'S STOCK BE MADE ONLY BY A TENDER OFFER FOR ALL SHARES;
- REQUIRE THAT STOCKHOLDER VOTES ON TAKEOVER MATTERS BE LIMITED TO THOSE WHO HAVE HELD SHARES FOR A SPECIFIED PERIOD PRIOR TO THE ANNOUNCEMENT OF THE PROPOSAL;
- REQUIRE THAT ACQUIRORS WHO CROSS THE 5% OWNERSHIP THRESHOLD MUST DELAY ADDITIONAL PURCHASES UNTIL 2 BUSINESS DAYS AFTER FILING A SCHEDULE 13D;
- REDUCE THE TAX CODE INCENTIVES FOR HIGHLY LEVERAGED ACQUISITIONS;
- REQUIRE THAT TENDER OFFERS BE OPEN FOR A MINIMUM OF 90 DAYS;
- LIMIT THE AMOUNT OF JUNK BONDS THAT CAN BE HELD BY FEDERALLY REGULATED SAVINGS INSTITUTIONS.

FINALLY, THE COMMITTEE SHOULD ALSO CONSIDER A PROPOSAL ADVANCED BY SOME AUTHORITIES THAT WOULD REQUIRE DISGORGEMENT OF 100% OF THE PROFITS ON A STOCK POSITION THAT AN INSTITUTION OR A CORPORATE RAIDER HAS NOT HELD FOR A SPECIFIED PERIOD OF TIME -- MUCH IN THE MANNER THAT THE LAW NOW PROVIDES FOR THOSE OF US WHO ARE CORPORATE OFFICERS.

I BELIEVE THESE PROPOSALS WOULD REPRESENT A CONSTRUCTIVE STEP TOWARD REDUCING THE PERNICIOUS EFFECT THAT HIGHLY LEVERAGED HOSTILE TAKEOVERS HAVE ON THE U.S. ECONOMY.

I BEGAN BY REFERRING TO THE POTENTIAL THREAT THE CURRENT TAKEOVER SITUATION PRESENTS TO THE PHYSICAL HEALTH OF EVERY AMERICAN, AND I HAVE NOT YET EXPLAINED WHAT I MEAN. ALLOW ME TO CONCLUDE BY DOING SO NOW.

TAKEOVERS ARE NOT JUST ABOUT RAIDERS AND MANAGERS AND SHAREHOLDERS, ABOUT BALANCE SHEETS AND BOTTOM LINES. THEY HAVE A MUCH BROADER IMPACT. WHEN IT COMES TO COMPANIES IN THE PHARMACEUTICAL INDUSTRY, FOR EXAMPLE, TAKEOVERS ARE ULTIMATELY ABOUT HUMAN LIVES.

THE PHARMACEUTICAL COMPANY THAT MAKES A SUBSTANTIAL AND SUSTAINED INVESTMENT IN R&D IS DOING WHAT IT MUST DO TO ACHIEVE IMPORTANT NEW DEVELOPMENTS IN RELIEVING, CURING OR PREVENTING HUMAN DISEASE. THIS IS WHAT THE PUBLIC EXPECTS OF US. WE ACCEPT THAT MANDATE AND WORK HARD TO FULFILL THOSE EXPECTATIONS. BUT THE "RULES OF THE GAME" THAT THE CONGRESS HAS ESTABLISHED REGARDING THE PRESENT TAKEOVER ENVIRONMENT THREATEN THAT AGREED UPON SOCIAL RESPONSIBILITY. IF YOU CREATE (EVEN BY OMISSION) A SITUATION WHERE A COMPANY IS DISCOURAGED OR DETERRED FROM MAKING THESE LONG-TERM INVESTMENTS, YOU MIGHT, JUST MIGHT, BE STOPPING IT FROM DEVELOPING CURES FOR CANCER, OR HEART DISEASE, OR ALZHEIMER'S, OR AIDS OR ANY OF THE DOZENS OF DISEASES ON WHICH WE ARE WORKING.

THAT IS NOT ALARMISM. IT IS REALITY. THE HEALTH OF AMERICAN BUSINESS AND THE HEALTH OF THE AMERICAN PUBLIC IN THIS REGARD ARE INSEPARABLE. AND THE TAKEOVER SITUATION WE NOW FACE IS A SICKNESS WE MUST ALL WORK TOGETHER TO CURE.

Testimony of Robert E Mercer
Senate Banking, Housing and Urban Affairs Committee
March 4, 1987

Mr Chairman and members of the committee, I am Robert E Mercer, chairman and chief executive officer of The Goodyear Tire & Rubber Company which last fall was the target of an attempted takeover.

I welcome this opportunity to describe the immediate and continuing impact of that attempted takeover on Goodyear, its shareholders, its employees and the communities in which we operate;

. . . And to add my voice to the growing concern over a runaway process wherein an elite band of raiders, speculators and financiers is perverting the free market system and dynamic capitalism into a quick money game with America's competitive position, economy and jobs as the chips.

Goodyear resisted the takeover in the conviction that it was in the best interests of the company and its real or long term shareholders versus those playing "musical shares." In the accelerated restructuring program required because of the takeover attempt, the corporation is becoming 12 percent smaller, three plants will be closed, employment is being reduced by 4,000 jobs, capital spending and research and development will be weighted toward projects with short term payout, and we are assuming a $4 billion debt load which will leverage the company to an unprecedented 80 percent of debt to total capitalization.

In Cumberland, Md., one of three communities in which we are closing plants, we will be able to maintain a subsidiary headquarters through the help of all levels of government.

There are those who say takeovers are inherently healthy for American industry, for America's competitive ability. Let me give you some historical perspective on that claim, from Goodyear's experience:

In 1977, at a time when the tire business worldwide was at a low ebb, we invested $260 million in a new state-of-the-art radial auto tire plant in Lawton, Oklahoma to assure our future competitive position in world markets.

With the same objective, during the 70s and early 80s, we invested in modernization of tire plants in Alabama and Tennessee and built a highly competitive wire plant in North Carolina to provide high quality steel wire for use in our tire product.

And in 1983, we invested $250 million to convert a Texas bias tire plant to a radial tire facility with costs that will meet Korean competition head-on when the start-up phase is completed later this month.

Those investments are responsible for the fact that Goodyear's U.S. tire plants are holding their own today in global competition. In many foreign countries, it takes from 25 to 50 man-minutes to manufacture a 13-inch tire. Our modern U.S. plants do it with less than ten. Our advanced technology and equipment make it possible to support higher American wages and benefits -- more than $20 an hour versus as low as $1.60 in Korea.

Had we been the object of a takeover attempt in the mid-70s, had we been forced into the short-term planning and investment now a way of life for American industry because of the takeover frenzy, none of those investments could have been made -- at least not in this country.

Nor would we still be operating two general products plants in Ohio which were carried through some very lean years by long term planning and now are doing a booming business and maintaining jobs.

Nor, had our R & D in the past concentrated only on the short term, could we be drawing now on a reservoir of advances and innovations that will keep our products competitive while we work our debt down to a normal level.

Our technical advances are of no small magnitude. For example, they have created a demand for our American-manufactured tires in Japan and contribute to our positive balance in foreign trade, this despite our sizeable imports of natural rubber.

Only because Goodyear has been a well-managed company, as a number of outside observers have attested; because we had planned and invested for the long term, were we able to survive the takeover attempt with a reasonably good prospect of maintaining and improving our competitive position in our tire and general products businesses.

Unless steps are taken to put takeovers of hostile nature into the same framework of due process, time and scrutiny required when public companies approach mergers or acquisitions on an open, negotiated basis, short term planning and investment will be the only course available for all of American industry. All hope of being competitive in global markets, including our own, will be lost. And America will continue to decline as a world economic power.

If you look at Goodyear's experience only through the eyes of a shareholder, was the takeover attempt and the ensuing restructuring all that bad? After all, our stock hit $56½ on February 20, compared with the low thirties last September before the assault was launched.

But what about the shareholders who sold 12½ million shares to the takeover group without knowing who they were or what they were up to; and those who sold another 22 million shares to the arbitrageurs, not having the skill of the "arbs" in reading the signs and signals of an impending move on the company?

What about the shareholders who based decisions on a "non-letter" filed with the takeover group's 13D and indicating the group was preparing to make a tender offer of $49? This had the effect of going public with a letter that never was mailed.

What of the future for the classic shareholder, looking for a stable investment, a dependable yield and reasonable growth based on long term planning versus spurts predictable only to those in a position to put a company's stock into play or force price growth through takeover or threat of takeover?

Ultimately, if manipulation of the free market system and financial instruments continues at the pace of the last couple of years, "deals" will succeed goods and services as America's gross national product.

I have discussed the shareholder; and I want to assure you that Goodyear's board and management considers our shareholders deserving of and entitled to prime consideration in our deliberations and decisions.

Yet, in any measurement of good conscience and responsibility, we cannot and will not ignore our duty toward our other constituencies -- our employees, plant town communities, suppliers, creditors, and of course our customers without whom there would be no business in which to invest.

All of these constituencies must be served fairly to maximize long term shareholder wealth. All, in one way or another, are stakeholders in the company. Their destinies are interwoven in many ways, including the broad issue of American industry's ability to be internationally competitive.

Many of these constituencies have been hurt as a consequence of the attempted takeover. Displaced employees represent one such group, although where feasible we tried to effect personnel cutbacks through such devices as early retirement programs. Another example is the communities in which payrolls and tax revenues will be reduced, not to mention the level of support we can afford for charitable activities.

Since the attempted takeover, we have asked ourselves what attracted the attack. We have had good management back through several changes of the guard. But some characteristics that we consider the strengths of the company also lure raiders in the present climate.

One was a good cash flow, which could easily be converted by cutting back in such areas as advertising, training, research and development. We also had several major divisions that could be sold at prices whose total would be higher than the stock market price for the corporation as a whole. Therein was our vulnerability.

An example was our energy segment. We had entered the oil and gas business, acquiring interests in offshore and onshore fields and undertaking construction of a California-to-Gulf Coast crude oil pipeline which made sense economically, environmentally and from a standpoint of national security. Environmental delays, now being handled, slowed our timetable; but the pipeline eventually will be improving cash flow for someone. Not Goodyear. We have to sell that business to help pare down our debt.

We also had announced our intention to expand our aerospace business with a goal of bringing the energy and aerospace segments, together, to equal the level of our tire business. Now, as part of our restructuring, we have sold our aerospace business which has been serving the public and the government since 1911.

In balancing our portfolio for long term growth, we did not lose focus on our core tire and rubber business, as charged by those who tried to take over the company.

In that core business, we increased our capital spending and our R & D, and improved our market share on a global basis. Much of our share gain was made against a foreign competitor -- supported by the French government -- which lost $1 billion in three years while we were making money.

We have concluded, as perhaps this committee is coming to believe, that all too many takeover attempts have little to do with the focus of the target company, the quality and wisdom of its management, or its potential to enhance shareholder value on a continuing basis;

. . . That instead, the prime motivation is a quick killing on a breakup of assets with little or no thought for the viability or competitive ability of what might be left over.

The lyrics of the siren song of the raiders usually contains familiar words -- "lost focus" . . . "undervalued assets". . . entrenched management" . . . "corpocracy" . . . "enhancement of shareholder value."

And as America wakes up to what is happening to its industrial base, a new verse has been added to the song -- "Entrenched management is running to Washington for protection."

Entrenched? Maybe, if you find any real security in an annual vote on your competence, or the ability of a shareholder to cast a "nay" anytime by dumping his stock. Maybe, if you disregard the fact that consumers vote every time they buy your products or services, or pass them up for those of a competitor.

Running to Washington? Yes, and high time. But not for walls to protect American industry from aboveboard mergers and acquisitions, even takeovers, friendly or hostile.

No, we are not advocating walls to protect industry. What we're urging is that Congress and the Administration tear down the walls of special privilege that protect raiders and speculators as they stalk their prey with their weapons of stealth and manipulation;

And secrecy, too, so far as the target or the public is concerned. However, as the current insider trading investigations have revealed, all too often not among themselves.

These walls of special privilege enable raiders and speculators to avoid the laws, rules and regulations which public corporations must observe, to force movement in stock prices by what amounts to deception and coercion, to disregard obligations to the public good while slandering the abilities and motives of those who accept such obligations.

I want to say for the record that I know of no link between insider trading activity and the attempted takeover of Goodyear. However, I must add that I don't find the whole scenario unfolding on Wall Street very reassuring about the future. And the SEC has not yet reported on its investigation of the attempt on Goodyear.

It is comforting to see that the regulatory system works. It is disturbing to see the level of abuse reached before the system kicked in.

For that reason, I sincerely hope Congress will move swiftly to level the walls of special privilege behind which raiders and speculators move in takeover attacks.

I don't pretend to know how to craft the careful legislation required to do that while preserving the ability to make healthy, productive mergers and acquisitions. It will, indeed, require delicacy and balance.

I do know that the key to hostile, destructive takeovers is made up of secrecy, stealth and speed -- the "bum's rush," so to speak. The key to reform is disclosure and deliberation.

To take hostility and unfairness out of the takeover scenario, more time and more information must be built into the process.

My suggestions would run along the lines of many of those you have been hearing -- earlier reporting to the SEC, closing the 13D filing window, extending the tender offer period.

Right now, it looks to many people out there, including hundreds of thousands of smaller shareholders -- that there's a lot of game playing going on in the executive suites of Wall Street.

We need to return mergers and acquisitions to a system based on honest dealing; to return it to the basic meaning of the word "securities" as the currency of our financial world.

Then, American industry can get back to the job of improving its competitive position, producing goods and services, and providing wealth for the whole economy, not just the dealmakers.

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The CHAIRMAN. Well, thank you very much, Mr. Mercer.

Mr. Chapman, the senior Senator from Florida is very anxious to introduce you and I understand that he is on his way. He is not a member of the committee but he is a fine Senator and so I'm going to skip over you for the time being and let Senator Chiles introduce you.

I'm going to go to Mr. Smithburg of Quaker Oats Co. Bobby Stewart was a classmate of mine in the 7th grade and 8th grade. It's a wonderful family and they've built a marvelous company. We're delighted to have you. Go ahead, Mr. Smithburg.

STATEMENT OF WILLIAM D. SMITHBURG, CHAIRMAN AND CEO, THE QUAKER OATS CO.

Mr. SMITHBURG. Thank you, Mr. Chairman. Yes, he was a classmate of yours a number of years ago. He is now Ambassador to Norway, as you know.

I am Bill Smithburg. I am chairman and CEO of the Quaker Oats Co. We are a $4 billion company both in sales and in market value today. We are a marketer of worldwide grocery products and toys through our Fisher Price Division.

Our mission is very simple. We are here to maximize our long-term value for our shareholders by balancing current competitive returns with investment in profitable growth for our future. So we are trying to focus simply on excellent operating performance for our shareholders and all constituencies.

QUAKER AS A POTENTIAL TARGET

But in today's environment, we sort of have to keep looking over our shoulder so to speak for activity in our stock which could signal a corporate raid. For example, just last year, 1986, we learned that Mr. Boesky had a sizable position in our stock and at the same time a number of financial analysts began to allude to our company as a potential takeover target. It looked like the process might begin. But it did not, of course, because of the situation that occurred after that.

In this climate, we simply have to spend too much time on defensive measures to assure ourselves that shareholder investments in Quaker are fully valued and that all shareholders are treated fairly. Much of that time, clearly, could be spent managing our operations to the benefit of shareholders and consumers long term.

I recall that in the early 1970's, Quaker had 2 years in which earnings declined. It was a problem. It was a problem we dealt with. We have had a prosperous decade ever since and the shareholder value was increased in that period 15 times.

I think in today's environment, maybe 1 year of an earnings decline would create—or even less than that—a situation where speculative raiders and other kinds of activities might prohibit shareholders from having that kind of long-term benefit because of the activities in the stock.

Of course, mergers and acquisitions are important to the Quaker Oats Co. and its shareholders. In fact, in the last few years our shareholders have benefited sizably from three important acquisitions, all in our core grocery business. These acquisitions were not executed just to do deals or for financial speculation; but rather, they were done to strengthen and expand our core operations for the long-term benefit of shareholders, for our customers, and, of course, for our employees.

So many business combinations are good for companies, are good for shareholders, and more important, from your point of view—in fact, from all of our points of view—many business combinations in the United States will help us as a country to become more efficient and competitive. So there are certainly desirable mergers and acquisitions. I think Quaker Oats is an example of several of them.

The truly undesirable side of mergers and acquisitions involves financial speculation with persons acquiring large stock positions in a company with no intention of ever operating these companies. In fact, they are gambling that someone else will want to acquire the company. These speculators put companies into play to reap inordinate short-term gains. They produce no jobs. They produce no products and they often do not certainly enhance productivity.

Instead, there is sheer action for its own sake to satisfy an overheated mergers and acquisitions industry which is simply too influential in today's market. It is the cause of a large amount of waste. Management's intellectual activities spent on these issues amounts to a misallocation of our human resources, a brain drain, if you will. There is also, of course, a financial drain that you've heard about several times this morning—the large fees, enormous fees paid to investment bankers and lawyers.

It all results in great wealth being exchanged, but little or no new wealth or new prosperity or new jobs being created for the future. The overheated merger and acquisition environment has simply led to outright abuses.

Though many of the abuses connected with mergers and acquisitions are clearly illegal, a lure of large sums has promoted people to sacrifice everything by trading on insider information.

Now we are all aware that Federal regulation is a very potent force. It can have unforeseen and even damaging consequences, especially legislation aimed at financial markets which are international in scope. Our country cannot afford to have legislation which causes us to lose ground internationally, but there are some things we can do to curb the ills of this speculative atmosphere.

My proposals are very similar to what you've heard this morning. Let's tighten up the percentage ownership and the timing requirements for announcing stock ownership. Let's extend the tender offer beyond the current levels. And also, perhaps we could adopt some new enforcement measures to deter abuses. For example, Congress could grant companies the right to sue to recover profits made from insider trading on their own stock. Treble damages, for example, would be a strong deterrent.

Mr. Chairman, I appreciate the opportunity to be with you this morning and look forward to your questions.

[The complete prepared statement of William D. Smithburg follows:]

The **Chairman**. Thank you very much, Mr. Smithburg.

Now we will go back to Mr. Chapman, chairman and CEO of Knight-Ridder. Go right ahead, sir.

STATEMENT OF ALVAH H. CHAPMAN, JR., CHAIRMAN AND CEO, KNIGHT-RIDDER, INC.

Mr. **Chapman**. Senator Proxmire, my name is Alvah Chapman. I'm the chairman and CEO of Knight-Ridder. We are a $2 billion communications company. Among other things, we publish newspapers in Akron, OH, where Mr. Mercer's company is headquartered and I am quite familiar with the situation that he was describing earlier and support his comments very strongly.

I would like to say that I am here not out of any concern or threat that might be coming to our company. Our company has 44 percent of our shares in the hands of our founding families, our officers, directors, and employees of our company. We don't feel that we are a potential target.

I am here as a concerned American businessman about what's happening to American business and what's happening to the economy of our country because of this takeover activity. And I'd like to make some comments about that.

I have prepared longer comments which presumably will be in the record but in your interest I will try to shorten this to the 5 minutes that you have requested.

The **Chairman**. Without objection, your statement will be printed in full in the record.

Mr. **Chapman**. Thank you, sir.

MOCKERY OF TRADITIONAL VALUES

Some people say that the hostile takeover craze is a spur to good management. I say just the opposite is true. Hostile takeovers are the strongest incentive to bad management in America today. Takeover mania has made a mockery of traditional American values.

Americans have long been proud of the free enterprise system and risk rewards that it produces. When a new product was conceived, it was produced with quality and efficiency. Markets were sought, companies were built, jobs were created, communities were benefited, and the national economy was strengthened.

Most companies that succeeded were managed for the long term. Now the corporate raiders are trying to turn the American economy into a money game. Hostile takeovers create no new wealth but merely shift ownership and replace equity with large amounts of debt.

The threat and/or reality of hostile takeovers without an orderly process to protect shareholders' interest encourages management to concentrate on the short term to the detriment of long-term development and growth.

Speculators may make quick, short-term profit, but at what cost? Employees may lose jobs, pension rights, and other benefits. Communities are disrupted. Major companies are sold off and sometimes closed as though the U.S. economy were a large Monopoly game.

Restructured companies rarely have budgets for research or start new businesses or contribute to the local United Way. The long-term investments rarely get priority.

One of my major concerns is that the human toll in takeovers is often ignored. How many of the takeover artists have ever visited a company, ever talked to an employee group, ever looked into the eyes of the people whose craftsmanship and ability and commitment built a company over many years?

There was an article in the December 14 Los Angeles Times which I will not describe in great detail, but it was written by a writer named John Lawrence. He talked about a young manager who was building his career and all of a sudden he was out of a job because the division in which he was involved decided that it couldn't be continued because they were under a threat of a takeover and had to close it down.

The human concern is a real concern of mine and to Peter Drucker, whose reputation in American business certainly needs no enhancement from me. Let me share with you Peter Drucker's comments.

Quoting from his recent book,

> In the case of takeovers, Drucker adds, the only rationale is to enrich somebody who has nothing to do with the performance of the enterprise and who quite admittedly has not the slightest interest in it. And this goes against the grain of employees who feel that the hostile takeover treats them as chattel and not as a resource, let alone as human beings.

So much for the damaging effects on companies and the people who work for them. I contend the takeover trend is equally damaging to the economy as a whole. I have great concern about using a national resource—namely, debt—in a way that creates no new jobs, no new businesses, and no lasting value of any kind.

We all know that total U.S. corporate debt has increased alarmingly in recent years. It's now $1.2 trillion, according to an article I read in the current issue of Time.

USE OF JUNK BONDS IN TAKEOVERS

One of the riskier aspects is the widespread use of junk bonds in financing many takeovers. Fortune Magazine in its March 16 issue tells us:

> Another kind of shocker is brewing, an unprecedented level of defaults by the companies issuing junk bonds. Approximately $125 billion of junk bonds are now on the books of American banks, savings and loans, mutual funds, and even some companies.

According to the Fortune article, the market for junk bonds has grown wildly, from $1.5 billion in 1978 to $7.4 billion issued in 1983, and $48 billion issued in 1986.

A consultant firm enlisted by Fortune examined 500 companies issuing junk bonds and concluded that 5.5 percent of them appear to be vulnerable.

At first glance, a 5.5 percent default rate might not appear to be that threatening. Look again. It's over three times the historical rate of default for publicly traded junk bonds. No one has speculated on what would happen when the economy slows down and interest rates go up. The prospect for a major financial catastrophe is present with junk bond financing. And if that catastrophe occurs, many innocent people—mutual fund investors, pension plan beneficiaries, banks, Savings and Loan's, and so forth could be seriously hurt.

So much for the problem. Let's focus on potential remedies. I must say that as a free enterpriser, I find myself somewhat uncomfortable asking for a Government solution, but I do see the national interest of my country being threatened and that's why I'm here about all of this.

As the head of Knight-Ridder, I have reluctantly come to the conclusion that only legislative remedies can solve this problem.

I have not prepared a specific proposal for you, but I do believe that any legislative solution should require earlier disclosure of a raider's position or intentions, firm financing commitments before a takeover bid is made, and consultation with the target company board of directors before a company is put in play.

I have read the plan of the Business Roundtable, of which I'm not a member, and it seems to make a great deal of sense to me. And since you've had that before you a number of times, I won't elaborate on their suggestions.

But I would like to just close by suggesting that there are several other factors in addition to those suggested by the Business Roundtable that might be considered.

The CHAIRMAN. Would you summarize those, Mr. Chapman? Your time is up.

Mr. CHAPMAN. I will summarize the ones in addition [illegible] If you would like me to summarize theirs I'll be glad to.

The CHAIRMAN. No. Why don't you summarize just the ones in addition.

Mr. CHAPMAN. Right. The ones in addition briefly require a raider to talk first to a company's board; second, stretch out the time of tender offers which is now 20 days, to provide a longer decision time for shareholders to decide; third, require that a target company not be liquidated for 2 years nor any of its assets be used for takeover collateral in this period.

Those three would be in addition to the ones that the Roundtable has proposed and others here have elaborated on.

I appreciate the opportunity to be here and I would be pleased to respond to any questions that you may have.

[The complete prepared statement of Alvah H. Chapman, Jr., follows:]

Testimony

of

William D. Smithburg

Chairman and Chief Executive Officer

The Quaker Oats Company

before

The Senate Committee on Banking, Housing and Urban Affairs

Washington, D.C.

March 4, 1987

1.

a. My name is William Smithburg. I am Chairman of the Board and Chief Executive Officer of The Quaker Oats Company, which is headquartered in Chicago, Illinois. Incorporated in 1906, Quaker is now a worldwide marketer of consumer products with sales of $3.7 billion for the fiscal year ended June 30, 1986. Our core businesses are worldwide groceries, which currently make up about 85 percent of sales, and Fisher-Price toys.

b. I myself was born, raised, and educated in the state of Illinois, where I still reside. I joined The Quaker Oats Company twenty-one years ago as a Brand Manager at the age of twenty-eight. In 1976, after ten years in the Company's cereals business, I became Executive Vice President, in charge of all of Quaker's U.S. Grocery Products. In 1979, I was named President and Chief Operating Officer, with the responsibilities of Chief Executive Officer added two years later. I was elected to my current position in 1983.

2.

a. Let me note at the outset that The Quaker Oats Company is not a corporate raider, nor are we currently the target of a raider. Our mission is to maximize value for our shareholders by balancing current competitive returns with investment in profitable growth for the future. So, we are trying to focus on operating excellence for shareholders. However, in the current environment, we have to keep looking over our shoulder, so to speak, for activity in our stock which could signal a corporate raid. For example, we learned in 1986 that Mr. Boesky had a large position in our stock and various reports of financial analysts have alluded to the Company as a potential takeover target. In this climate, we have to spend too much time on defensive measures to make sure that the shareholders' investment in Quaker is fully valued and that all shareholders are treated fairly. It is time that could be spent on managing our operations for the benefit of both shareholders and consumers.

b. Of course, mergers and acquisitions are important to The Quaker Oats Company and its stockholders. In the last several years, our shareholders have benefitted from three acquisitions, all in our core grocery businesses. These acquisitions were not executed just to do deals or for financial speculation, but to strengthen and expand our core operations.

3.

a. Many business combinations are good for the companies and stockholders involved. More important, from your point of view, I think many business combinations help the United States become more efficient and competitive.

b. But even these good mergers and acquisitions have some unavoidable short-term effects, lost jobs being the most important and obvious among them. However, it is also true that large increases in jobs often result from mergers and acquisitions over time. Many combinations eventually result in growth for the acquired businesses as efficiencies are achieved or marketing expertise strengthens demand. However, new jobs are often created gradually. Hence, they don't receive the same attention as lost jobs.

4.

a. The truly undesirable side of mergers and acquisitions involves financial speculation, with persons acquiring large stock positions in companies with no intention of ever operating these companies. In fact, they are gambling that someone else will want to acquire the company. These speculators put companies "into play" to reap inordinate gains. They produce no jobs, no products. They do not add to U.S. productivity. Instead, there is sheer action for its own sake to satisfy an overheated mergers and acquisitions industry, which is too influential. It is the cause of a large amount of waste. Management's intellectual energy spent on these issues amounts to a misallocation of human resources, a brain drain, if you will. There is also a financial drain in the large fees paid to investment bankers and lawyers. It all results in great wealth being exchanged but no new wealth being created. The overheated mergers and acquisitions environment has also led to outright abuses.

b. Though many of the abuses connected with mergers and acquisitions are already illegal, the lure of huge sums has prompted people to sacrifice everything by trading on insider information.

5.

It is not easy to legislate against such an atmosphere. As you know better than I, federal legislation is a very potent thing. It can have unforseen and damaging consequences, especially legislation aimed at financial markets, which are international in scope. Our country can not afford to have legislation which causes us to lose ground in international competition. But there are things we can do to curb the ills bred by the current speculative atmosphere. My proposals are as follows:

a. tighten the percentage ownership and timing requirements for announcing stock ownership in a public company and eliminate the current special treatment of institutional investors in these areas.

b. adopt some new enforcement measures to deter abuses. For example, Congress could grant companies the right to sue to recover profits made from insider trading in their own stock. Treble damages would be a strong deterrent. This type of Congressional action would supplement the limited enforcement resources of both the SEC and professional shareholder class-action lawyers.

6.

I appreciate this opportunity to present my views and would be pleased to respond to your questions. Thank you.

STATEMENT BEFORE THE SENATE BANKING COMMITTEE

WEDNESDAY, MARCH 4, 1987
Alvah H. Chapman, Jr.
Chairman and Chief Executive Officer
Knight-Ridder, Inc.
Miami, Florida

SOME PEOPLE SAY THE HOSTILE TAKEOVER CRAZE IS A SPUR TO GOOD MANAGEMENT. I SAY JUST THE OPPOSITE IS TRUE. HOSTILE TAKEOVERS ARE THE STRONGEST INCENTIVE TO BAD MANAGEMENT IN AMERICA TODAY.

TAKEOVER MANIA HAS MADE A MOCKERY OF TRADITIONAL AMERICAN VALUES!

AMERICANS HAVE LONG BEEN PROUD OF THE FREE ENTERPRISE SYSTEM AND RISKS/REWARDS THAT IT PRODUCES. WHEN A NEW PRODUCT WAS CONCEIVED, IT WAS PRODUCED WITH QUALITY AND EFFICIENCY, MARKETS WERE SOUGHT, COMPANIES WERE BUILT, JOBS WERE CREATED AND COMMUNITIES WERE BENEFITTED, AND THE NATIONAL ECONOMY STRENGTHENED.

MOST COMPANIES THAT SUCCEEDED WERE MANAGED FOR THE LONG TERM.

NOW THE CORPORATE RAIDERS ARE TRYING TO TURN THE AMERICAN ECONOMY INTO A MONEY GAME.

HOSTILE TAKEOVERS CREATE NO NEW WEALTH, BUT MERELY SHIFT OWNERSHIP AND REPLACE EQUITY WITH LARGE AMOUNTS OF DEBT.

THE THREAT AND/OR REALITY OF HOSTILE TAKEOVERS, WITHOUT AN ORDERLY PROCESS TO PROTECT SHAREHOLDERS' INTEREST, ENCOURAGES MANAGEMENT TO CONCENTRATE ON THE SHORT TERM, TO THE DETRIMENT OF LONG-TERM DEVELOPMENT AND GROWTH.

SPECULATORS MAY MAKE QUICK SHORT-TERM PROFIT -- BUT AT WHAT COST? EMPLOYEES MAY LOSE JOBS, PENSION RIGHTS AND OTHER BENEFITS; COMMUNITIES ARE DISRUPTED; MAJOR COMPANIES ARE SOLD OFF AND SOMETIMES CLOSED, AS THOUGH THE U.S. ECONOMY WERE A LARGE MONOPOLY GAME.

"RESTRUCTURED" COMPANIES RARELY HAVE BUDGETS FOR RESEARCH OR START NEW BUSINESSES OR CONTRIBUTE TO THE LOCAL UNITED WAY. LONG-TERM INVESTMENTS RARELY GET PRIORITY.

ONE OF MY MAJOR CONCERNS IS THAT THE HUMAN TOLL IN TAKEOVERS IS OFTEN IGNORED. HOW MANY OF THE TAKEOVER ARTISTS HAVE EVER VISITED A COMPANY, EVER TALKED TO AN EMPLOYEE GROUP, EVER LOOKED INTO THE EYES OF THE PEOPLE WHOSE CRAFTSMANSHIP AND ABILITY AND COMMITMENT BUILT A COMPANY OVER MANY YEARS?

JOHN F. LAWRENCE DEALT WITH THE HUMAN TOLL OF TAKEOVER MANIA IN AN ARTICLE IN THE DECEMBER 14, 1986 LOS ANGELES TIMES.

LAWRENCE'S ARTICLE REFERS TO "THE YOUNG FELLOW WHO HAD WORKED HARD AND FINALLY WON PROMOTION TO MANAGER OF A GEMCO STORE. HE'S NOW UNEMPLOYED BECAUSE LUCKY (STORES), UNDER THREAT FROM TAKEOVER SPECIALIST ASHER B. EDELMAN, BELIEVED THAT IT NO LONGER HAD THE TIME TO SPRUCE UP ITS GEMCO CHAIN AND GET IT HEALTHY. IT CLOSED THE CHAIN, AND THE YOUNG MANAGER IS NOW OUT OF A JOB."

LAWRENCE'S ARTICLE QUOTES THE WELL KNOWN PETER DRUCKER FROM HIS LATEST BOOK, 'THE FRONTIERS OF MANAGEMENT':

"THERE IS A GOOD DEAL OF EVIDENCE THAT PEOPLE IN AN ORGANIZATION . . . WILL ACCEPT EVEN THE MOST PAINFUL ADJUSTMENT, SUCH AS THE CLOSING OF A BUSINESS OR THE SALE OF PARTS OF IT, IF THE RATIONALE IS ECONOMIC PERFORMANCE OR THE LACK THEREOF.

"IN THE CASE OF TAKEOVERS, HOWEVER," DRUCKER ADDS, "THE ONLY RATIONALE IS TO ENRICH SOMEBODY WHO HAS NOTHING TO DO WITH THE PERFORMANCE OF THE ENTERPRISE AND WHO, QUITE ADMITTEDLY, HAS NOT THE SLIGHTEST INTEREST IN IT. AND THIS GOES AGAINST THE GRAIN OF EMPLOYEES WHO FEEL THAT THE HOSTILE TAKEOVER TREATS THEM AS 'CHATTEL' AND NOT AS A 'RESOURCE,' LET ALONE AS HUMAN BEINGS."

SO MUCH FOR THE DAMAGING EFFECTS ON COMPANIES AND THE PEOPLE WHO WORK FOR THEM. I CONTEND THE TAKEOVER TREND IS EQUALLY DAMAGING TO THE ECONOMY AS A WHOLE.

I HAVE GREAT CONCERN ABOUT USING A NATIONAL RESOURCE, I.E., DEBT, IN A WAY THAT CREATES NO NEW JOBS, NO NEW BUSINESSES AND NO LASTING VALUE OF ANY KIND. WE ALL KNOW THAT TOTAL U.S. DEBT HAS ESCALATED ALARMINGLY IN RECENT YEARS.

ONE OF THE RISKIER ASPECTS IS THE WIDESPREAD USE OF JUNK BONDS IN FINANCING MANY TAKEOVERS.

FORTUNE MAGAZINE, IN ITS MARCH 16 ISSUE, TELLS US: "ANOTHER KIND OF SHOCKER IS BREWING . . . AN UNPRECEDENTED LEVEL OF DEFAULTS BY THE COMPANIES ISSUING JUNK BONDS."

APPROXIMATELY $125 BILLION OF JUNK BONDS ARE NOW ON THE BOOKS OF AMERICAN BANKS, SAVINGS AND LOANS, MUTUAL FUNDS AND EVEN SOME COMPANIES.

ACCORDING TO THE FORTUNE ARTICLE, THE MARKET FOR JUNK BONDS HAS GROWN WILDLY FROM $1.5 BILLION ISSUED IN 1978 TO $7.4 BILLION IN 1983; AND $48 BILLION IN 1986.

A CONSULTING FIRM ENLISTED BY FORTUNE EXAMINED 300 COMPANIES ISSUING JUNK BONDS AND CONCLUDED THAT 5.5% OF THEM APPEARED TO BE VULNERABLE.

"AT FIRST GLANCE, 5.5% MIGHT NOT APPEAR THAT THREATENING. LOOK AGAIN: IT'S OVER THREE TIMES THE HISTORICAL RATE OF DEFAULT FOR PUBLICLY TRADED JUNK BONDS. . ."

NO ONE HAS SPECULATED ON WHAT WILL HAPPEN WHEN THE ECONOMY SLOWS DOWN AND INTEREST RATES GO UP. THE PROSPECT FOR A MAJOR FINANCIAL CATASTROPHE IS PRESENT WITH JUNK BOND FINANCING.

AND IF THAT CATASTROPHE OCCURS, MANY INNOCENT PEOPLE -- MUTUAL FUND INVESTORS, PENSION PLAN BENEFICIARIES, BANKS AND SAVINGS AND LOANS, ETC. -- COULD BE SERIOUSLY HURT.

SO MUCH FOR THE PROBLEM. LET'S FOCUS ON POTENTIAL REMEDIES.

I MUST SAY THAT AS A FREE ENTERPRISER, I FIND MYSELF SOMEWHAT UNCOMFORTABLE ASKING FOR A GOVERNMENT SOLUTION.

BUT I DO SEE THE NATIONAL INTEREST OF MY COUNTRY BEING THREATENED BY ALL OF THIS; AND AS THE HEAD OF KNIGHT-RIDDER, I'VE RELUCTANTLY COME TO THE CONCLUSION THAT ONLY LEGISLATIVE REMEDIES CAN SOLVE THIS PROBLEM.

I HAVE NOT PREPARED A SPECIFIC PROPOSAL FOR YOU. I DO BELIEVE THAT ANY LEGISLATIVE SOLUTION SHOULD REQUIRE:

(A) EARLIER DISCLOSURE OF A RAIDER'S POSITION OR INTENTIONS;

(B) FIRM FINANCING COMMITMENTS BEFORE A TAKEOVER BID IS MADE; AND

(C) CONSULTATION WITH THE TARGET COMPANY BOARD OF DIRECTORS BEFORE A COMPANY IS "PUT INTO PLAY."

A PLAN OFFERED BY THE BUSINESS ROUNDTABLE (OF WHICH I AM NOT A MEMBER) SEEMS TO MAKE A GREAT DEAL OF SENSE TO ME.

I AM SURE YOU ARE FAMILIAR WITH THAT PLAN, BUT LET ME SUMMARIZE IT AGAIN FOR YOU.

A. A THRESHOLD NUMBER OF SHARES THAT A RAIDER MIGHT ACQUIRE BY A TENDER OFFER OR OTHERWISE SHOULD BE ESTABLISHED, ABOVE WHICH HE MUST OFFER TO PURCHASE ALL SHARES OF THE TARGET COMPANY AT NO LESS THAN THE SAME PRICE. A LEVEL OF UP TO 15% OF THE OUTSTANDING VOTING SECURITIES OF THE COMPANY WOULD BE AN APPROPRIATE THRESHOLD. ABOVE THAT LEVEL THE APPROVAL OF A MAJORITY OF THE BOARD OF DIRECTORS SHOULD ALSO BE REQUIRED.

B. THE BOARD WOULD THEN DELIBERATE AND APPROVE OR DISAPPROVE THE OFFER WITHIN TEN CALENDAR DAYS. IF THE BOARD APPROVED, THE OFFER WOULD PROCEED UNDER THE PRESENT RULES. IF THE BOARD DISAPPROVED, THE OFFEROR COULD REQUEST THE CALLING WITHIN FIVE DAYS OF A SPECIAL MEETING OF SHAREHOLDERS TO CONSIDER THE OFFER. SHAREHOLDER VOTES WOULD BE SOLICITED THROUGH A PROXY STATEMENT CONTAINING FULL DISCLOSURE OF THE OFFEROR'S FINANCING ARRANGEMENTS AND PLANS FOR THE COMPANY, AS WELL AS THE BOARD'S REASONS FOR REJECTING THE OFFER.

C. A VOTE TO ACCEPT THE OFFER WOULD REQUIRE AN ABSOLUTE MAJORITY (51%) OF THE OUTSTANDING SHARES. ONLY SHAREHOLDERS OF RECORD AT THE CLOSE OF BUSINESS ON THE DAY BEFORE THE ACQUIRER SUBMITS ITS PROPOSED OFFER TO THE TARGET BOARD (OR AN EARLIER DATE IF THE MARKET IS SIGNALED CONCERNING THE FORTHCOMING BID) WOULD BE ENTITLED TO VOTE.

D. IF THE PROPOSAL RECEIVES THE REQUISITE SHAREHOLDER APPROVAL, THE BID THEN GOES FORWARD SUBJECT TO THE PRESENT RULES REGARDING TAKEOVERS.

OTHER FACTORS THAT SHOULD BE CONSIDERED ARE THE FOLLOWING:

✓ REQUIRE A RAIDER TO TALK FIRST TO THE COMPANY'S BOARD.

✓ STRETCH OUT THE TIME OF TENDER OFFERS (NOW TWENTY DAYS) TO PROVIDE A LONGER DECISION TIME FOR SHAREHOLDERS TO DECIDE.

✓ REQUIRE THAT A TARGET COMPANY NOT BE LIQUIDATED FOR TWO YEARS, NOR ANY OF ITS ASSETS BE USED FOR TAKEOVER COLLATERAL IN THIS PERIOD.

✓ IF TAKEOVER ABUSES ARE CURBED, SOME OF THE EXTREME DEFENSIVE TACTICS SUCH AS GREENMAIL ALSO SHOULD BE CURBED.

THANK YOU FOR GIVING ME THE OPPORTUNITY TO SHARE THESE VIEWS WITH YOU. I WOULD BE HAPPY TO ELABORATE IF YOU WOULD SO DESIRE.

-30-

The **Chairman**. Thank you very much, Mr. Chapman, for a fine presentation.

Chairman William Wall, CEO of Kansas Power & Light. Go right ahead, sir.

STATEMENT OF WILLIAM E. WALL, CHAIRMAN OF THE BOARD AND CEO, THE KANSAS POWER & LIGHT CO.

Mr. **Wall**. Thank you very much, Mr. Chairman.

May it please the committee, my name is Bill Wall. I'm chairman of the board and CEO of Kansas Power & Light Co. We distribute gas and electricity to about 1,300,000 farms, homes, businesses in Kansas and parts of Missouri and Oklahoma.

Everything that's been said today I endorse and I will not belabor you by going through a prepared statement. I would like to make just a couple of observations, however.

The **Chairman**. Without objection, your statement will be printed in full in the record.

Mr. **Wall**. Thank you very much, Mr. Chairman.

I would like to observe, first of all, that there really isn't very much new under the sun, including on Wall Street. In the 1920's, the use of leverage, pyramiding, pooling, speculation, inside trading were all commonplace, and it hit particularly my industry—the public utility industry.

Fifty years ago, the Congress reacted to that by passing the Public Utility Holding Company Act. That's one reason I believe that utilities so far have not been put into play, because when one acquires a certain amount of stock in a utility you take on a good deal of baggage from the Securities and Exchange Commission by way of regulation.

APPROACHED BY INVESTMENT BANKING FIRMS

Even though many of us, my own company included, have been called cash cows a rather inelegant phrase, we have not been objects of hostile raids. However, we have not been spared from the so-called MBO or LBO. That's the inside job. I have personally been approached by representatives of one of the investment banking firms that's most notoriously linked to this kind of activity.

It was told to me that, with the proper handling of things, I could become a very wealthy man—something that I was interested in pursuing further, at least the conversation. It involved getting a couple of members of my board to go along with me, all this being entirely legal. I would be able to borrow a huge amount of money, far beyond any assets I have, and even better, I wouldn't even have to pledge what little assets I have by way of a home or car. I would be able to borrow this money. It would be without recourse. It would be secured only by the stock in my own company.

However, to make all this work, of course, it would require us to operate the company in such a fashion that we would squeeze every dollar that was possible out of it.

Now that might not be particularly dangerous to a company manufacturing toys, but a utility providing essential service to a part of the country, to operate it with no other motive than the maximization of profits—in this case my own—it seems to me would be destructive to good maintenance, good operations to our customers' interest and to our employees' interest. It's something I think that ought to be watched. It's an idea that hasn't been translated into action yet, but I expect that we will be hearing about something like that before too long.

Recently, I gave a speech on this subject and I was challenged by Mr. T. Boone Pickens to a debate. He was quoted as saying he would debate me "anywhere, high noon or midnight." I suggested the debate be held in Bartlesville, OK, where my company provides the gas and they know Mr. Pickens very well. He responded in writing that my suggestion was "the goofiest idea I've heard in 25 years." [Laughter.]

We haven't been able to agree on a place for the debate, but I am becoming more and more convinced that Bartlesville would not only be the right place for that debate, but I think it would be a very good place for this committee to consider holding a field hearing, because Bartlesville is a pretty good laboratory to study the wreckage, both human and corporate, that lies in the raider's wake.

For unlike a Gulf Oil or Unocal where a big city can mask the pain, Phillips Petroleum so dominates the social and economic life of Bartlesville that the damage is starkly evident.

Someone once said that in a situation like this that statistics are people with the tears wiped away. And there are a lot of statistics in Bartlesville. Phillips Petroleum, a once great corporation in a thriving community, is now groaning under a huge burden of debt. They got a double dose—Mr. Pickens first and Mr. Icahn second—groaning under this burden of debt that makes them live in a world in which they have to have $20 a barrel for oil. They do not have the flexibility that a good underpinning of equity capital in their enterprise which would have permitted them a resiliance to pass through cycles in the economy of their own industry.

I think that the raiders are much like what F. Scott Fitzgerald said about the rich—they are careless with people.

I'm lucky to be able to run a utility which is a specially favored kind of corporation that has the high privilege to provide an essential service, but I think every corporation gets its charter from the people through government. They all are protected with the mantle of limited liability and that means to me that they all have a responsibility to the stakeholders in their enterprise and to their community.

I challenge the maximization of profit as being the only goal of a corporation, even if that does come from the Harvard Business School.

And I would close with a quote from the Harvard Business School's current bulletin which says—this actually is a quote from Keynes, which you would expect at the Harvard Business School:

> Speculation may do no harm as bubbles on a steady stream of enterprise, but the position is serious when enterprise becomes a bubble on a whirlpool of speculation.

Thank you.

[The complete prepared statement of William E. Wall follows:]

Yet as long as money in such huge and usually riskless ways can be made, the game goes on. Management of target companies will continue to be publicly abused, and insulted, and the junk bonds will pour forth.

And to make sure all this keeps going, Mr. Pickens has organized a national group, ostensibly to protect shareholders' rights, but actually to keep the decks clear for freebooting among America's most successful enterprises.

Now it's true, many American businesses are poorly run, and there are incompetent, entrenched managements that need replacing. And it's also true stockholder rights need better protection. There are profound reforms in both areas I would press for and support. But to accept the raider's claim that his cause is noble, that he is only engaged in what one famous economist in another context called "creative destruction," is to add gullibility to victimization.

Perhaps Peter Drucker posed the question best in a recent article in The Wall Street Journal he titled, "The Crisis of Capitalism."

"Can a modern democratic society tolerate the subordination of all other goals and priorities in a major institution, such as the publicly owned corporation, to short-term gain? And can it subordinate all other stakeholders to one constituency -- the shareholder."

I don't believe American enterprise faces the Hobson's choice of poor management or the raider's scourge. I don't believe we have to surrender to those who, as was said of the Bourbons, know the price of everything but the value of nothing. I don't believe America's great corporations have no past or future, only a present worth to be monetized by financial manipulations.

We need to remember that our separate businesses are parts of a larger economy, and how that economy works is everybody's business. Just as war is too important to be left to generals, so, too, the great enterprises of our Nation can't be left to the raider's caprice. We in management are privileged to engage in commerce, but we do so in trust and under law. We had better be more attentive to that trust, and we had all better support wise laws, before it's too late.

The CHAIRMAN. Thank you, Mr. Wall, very much.

Our final witness is Clarence Johnson, chairman and CEO of Borg-Warner.

STATEMENT OF CLARENCE E. JOHNSON, PRESIDENT AND CEO, BORG-WARNER CORP.

Mr. JOHNSON. Good afternoon, Mr. Chairman, and other members of the committee.

For the record, I am Clarence E. Johnson, president and CEO of Borg-Warner Corp.

Our company has a direct interest in the issue before this committee, for Borg-Warner itself is threatened by takeover. I can't tell you today how this threat will be resolved, but undoubtedly it will be resolved well before the enactment of legislation.

The public policy issue that brings us together today, however, is not corporate takeovers. Corporate mergers and acquisitions are an essential element of our free market. Acquisitions can promote economic efficiency and growth. They help build stronger, more competitive companies and increase shareholder value. And an unfriendly offer to purchase control of a corporation plays an important role. It allows an acquisition to proceed, despite the opposition of recalcitrant management.

The problem lies with the use of threatened takeovers, stock accumulations, and even the press to manipulate the market. The rumors, the stories, the threats create massive speculation in a stock like Borg-Warner's.

Seldom do these speculators intend to manage the company they target, and nothing of value is created by their acts. No plants are built; no jobs are created. But huge profits are made and often at the expense of other shareholders and the Nation. And with easy access to credit, these speculators can create enough financial leverage to bring some of America's largest corporations to their knees.

HOW THE GAME WORKS

Let me explain briefly how the game works. A small group of individuals—the arbitrageurs, raiders, and investment bankers—work together to create market speculation in the stock of a targeted company. The raiders purchase a large block of the company's stock, the arbitrageurs create a market for the stock, and the bankers arrange the financing.

The object is not control, but quick profits for the arbitrageur, greenmail for the raider, and fees for the banker.

Their activities con other investors into believing that a takeover bid looms. The price moves up in anticipation that a raider is about to pay a premium for control. Yet that assumption is usually far from the truth.

Once the market anticipates the takeover, the raider can approach the target for greenmail, attempting to force the company to buy back its stock at a premium.

If the raider receives greenmail from the company, the stock price drops and other investors pick up the pieces, usually the loyal investors that have been with the company for a good long while.

And the targeted company is left with a debt burden that inhibits growth.

If this dangerous trend continues, American business can't retain its competitive position in the world marketplace. Successful companies manage from a long-term perspective, focusing attention on multiyear capital investments and R&D to provide a consistently high return for shareholders.

We at Borg-Warner, for example, have been restructuring the company in a steady evolution that increased the value to shareholders without causing trauma to the organization. Could we have done better than we did? Yes, not everything we tried worked. But we accomplished a great deal.

From 1981 through 1985, before we went into play, our total return to shareholders, which includes dividends and appreciation, averaged almost 24 percent, compared with not quite 14 percent for the Standard & Poor's 400. During those same years, we reinvested $1 billion in our businesses in capital expenditures and more than $300 million in R&D.

And we did this without overleveraging the company.

Yet the current frenzy forces companies to provide immediate returns for Wall Street, creating a classic catch-22. Responding to short-term pressures can result in a higher stock price, but only for the short term and only at the expense of strengthening the business for the long run. American companies will not be able to meet international competition unless they are able to focus on capital expansion and research and development.

The Nation needs legislation that will restore balance to the system. Otherwise, this country will lose its competitive edge and witness an extraordinary transfer of wealth and power to Wall Street.

Corporations should produce goods and services, not manipulation and speculation.

This problem need not be solved by restricting takeovers in their entirety. Instead, Congress must limit the ability of a few individuals to manipulate the stock market under the implied threat of a takeover.

Borg-Warner Corp. advocates a legislative proposal which strikes a proper balance. The proposal is simple and it addresses the cause of most of the abuses and especially the pressures for greenmail.

The centerpiece of this proposal would require a raider to make a tender offer for all of the targeted company's shares once a threshold level of, say, 10 percent is reached.

Under existing law, a tender offer is not well-defined, and no parameters are established for when an offer must be made. So raiders and speculators are free to threaten a hostile takeover until the targeted company buys them out.

The CHAIRMAN. Mr. Johnson, your time is up.

Mr. JOHNSON. The proposed bill would reduce such pressures while permitting legitimate takeovers to continue. I think we are very consistent with previous testimony and we appreciate the opportunity to appear before this committee this afternoon.

[The complete prepared statement of Clarence E. Johnson follows:]

TESTIMONY BY WILLIAM E. WALL

CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER

THE KANSAS POWER AND LIGHT COMPANY
(KPL GAS SERVICE)

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

U.S. SENATE

Washington, D.C.

March 4, 1987

Something's been happening to American business lately, something that's never happened before, something I believe has hurt and continues to hurt our entire economy. Just how much we won't know with certainty until the next inevitable economic downturn.

I'm talking about the current take-over craze -- deal mania -- corporate raids -- the leveraged buy-outs -- the frenzied finance that has filled the business pages lately, and made some corporate raiders into household names, and others notorious.

Let me begin, if I may, by establishing my ground. I support and have personally engaged in corporate restructuring and reorganization. Indeed, I work for a company that is the product of dozens of past mergers and consolidations, one of which I directed. That, after all, is the natural evolution of business in America, creating new organizational forms to meet the competitive demands of the market. This has meant mergers, consolidations, the creating of new subsidiaries and the liquidation of old ones.

Yet the point of such efforts, that is until recently, has been to create better and stronger companies, enterprises with the muscle to develop new markets, to expand facilities, to create new jobs; in short, businesses that would add wealth and stability to the economy of the region and the Nation.

Implicit in such efforts was a compact between investor, manager and worker that today's short-term profits were not all that mattered, that long-term goals had to be served as well; and that what the business was engaged in was important, with responsibilities to the larger society.

Because in the absence of these values, Corporate America would have no ethical call on the time and talents of the Nation's best and brightest. Without them, great universities could not justify the application of their scholarship to the study of business. But perhaps above all, without some higher purpose to commerce and industry, those of us engaged in its pursuit would have no more to show for our working lives than money grubbing.

Yet today I fear that idea has become outmoded, and in some quarters even laughable.

Today, a new doctrine is being preached. It holds that every publicly held American company is up for auction. That no business is worth more than its break-up value. If a company is worth more dead than alive, then it should be killed, and its assets distributed as a liquidation dividend to its shareholders.

A corollary of this new creed is that if a company can carry more debt, then it has a duty to borrow to the maximum. Not to use the money to build a new plant, to create new jobs, to develop a new product, but to leverage up the company, to trade on the equity, to get the price of the company's stock as high as possible. In short, to "Enhance Shareholder Values."

This sea-change in American business thinking coincides precisely with the advent of the "Corporate Raider," the take-over artist. For the "Raider" has taught American business a new approach to the management of assets, one unhappily being learned too well.

The corporate raider's strategy is simple enough. Find a company whose assets the stock market at some moment in time has undervalued, then unlock those hidden values by applying leverage.

The message to Corporate America is clear. If the stock market isn't putting the highest possible price on your company's stock today, you are vulnerable to the corporate raider.

The raider follows a predictable course in stalking a company. After taking a small position in the company's stock, he begins a campaign of abuse and insult aimed at the target company's management, portraying it as unresponsive and uncaring about the stockholder's interest; as selfish little men concerned only with their own salaries and bonuses; arrogant men who don't recognize their highest duty as managers is to enhance shareholder values. This billingsgate aimed at the corporate suites is, of course, sure-fire grist for the journalistic mills, because most of us love to see the mighty humbled, to see the stuffed shirts get theirs. The raider knows this and uses it with great skill. He appears on TV and public platforms as often as possible to undermine investor confidence in the management of American enterprise, and he has been successful.

So successful, that he has been able to excuse piously his greenmail payoff, or the breakup and sale of a once great and going concern, by simply saying, "The stockholders made money on the deal."

That's it. That's all he has had to say in explanation and justification. Forget the people who worked for and built the company; forget the communities who depended upon it; forget the management who had the courage to reinvest today's earnings to provide for tomorrow's growth, who put the very values into the company the raider has now exploited. None of that matters. What matters is that the stockholders one day were offered more for their stock than it was quoted for on the New York Stock Exchange a month or so earlier.

The fact that as much as half the stock of a company a raider puts into play when he begins his raid rushes into the hands of the Ivan Boesky-like arbitrageurs, and a good part of the rest is owned by the raider and speculators who feed on raids, is passed off as just so much sour grapes.

Well, every management knows there is no great secret about how to enhance shareholder value and keep the raider from the door.

The way to cater to short-term greed is to trade on the equity, to leverage up the company. This means to borrow, to see to it that most of the money invested in the enterprise is owed instead of having someone's savings actually committed to it in a risk-taking ownership role. And Corporate America has made impressive moves in this direction. Just since 1984 over $220 billion of equity has been retired from company balance sheets and replaced by debt.

Some of this has been done by the companies Allen Sinai, economist for Shearson Lehman, had in mind when he asked the question, "Is the manufacturing sector of our economy slowly liquidating itself?"

These are the companies who have forgotten -- or chosen not to recognize -- that the miracle of leveraging -- that is, replacing equity with debt -- can work for profit and loss statements in good times, can cause mayhem in bad times as the effect of the business cycle is exaggerated.

These are the companies The Institutional Investor had in mind in its November, 1986 issue -- when it said, "Many companies, particularly some of the more hyperleveraged megabuyouts, are undoubtedly teetering on the cliff's edge."

And these are the companies Edward Yardeni, economist for Prudential Bache, was talking about when he said "American management mentality has changed from operations to the business of financial manipulation because of the short-term view of stockholders. Companies are managing their books rather than their companies."

But debt is seductively attractive because not only does it provide in the short run a higher return on equity, not only is the interest paid deductible for tax purposes, but just as important, it foils the raider. For when the management of the target company has already used up the company's credit -- its borrowing power -- there's nothing left for the raider to buy the company with.

And that, of course, is how the raider works. His target must have assets and debt-carrying strength to buy itself for him. Ted Turner had the gall to try to take over CBS not with his own money, but with paper promises, promises he proposed to redeem in part by selling off pieces of CBS. The rest he would repay by borrowing to the hilt on what wasn't sold. In other words, CBS was to buy itself for Ted Turner. And why not? He had seen the same tactics work before, many times. And if it failed, he had seen other raiders in their very failure make a fortune in greenmail.

Now if all of this was just some businessman's game, something the rest of us could watch with bemusement from insulated safety, it would hardly be worth commenting on. But this whole sordid business is now casting its sinister shadow over the entire economy. For in addition to a mountain of corporate debt, the raider has brought us something else: the well named junk bond.

JUNK BONDS, AS YOU KNOW, LOOK LIKE REAL BONDS, BUT THEY PAY HIGH RATES OF INTEREST AND HAVE LITTLE OR NOTHING BEHIND THEM. A REAL BOND IS A PROMISE TO PAY INTEREST AND PRINCIPAL SECURED BY SOME WORTHY ASSET. THE BETTER QUALITY THE SECURITY AND THE MORE TIMES THE COMPANY CAN EARN THE INTEREST ON THE BOND, THE HIGHER THE BOND IS RATED BY STANDARD & POOR'S, MOODY'S AND FITCH.

TEN YEARS AGO, 60 COMPANIES IN THIS COUNTRY HAD BONDS OUTSTANDING THAT WERE RATED "TRIPLE A." TODAY, ONLY 26 CAN CLAIM THAT RATING.

JUNK BONDS, OF COURSE, CAN'T STAND THE SCRUTINY OF THE RATING AGENCIES. THEY ARE UNRATED. EVEN THOSE WHO FLINCH FROM THE TERM CALL THEM "BELOW INVESTMENT GRADE." THEY ARE, THAT IS, JUNK, OFFERING A HIGH INTEREST RATE TO THOSE WHO NEED THE MONEY TODAY, AND ARE WILLING TO LET TOMORROW LOOK AFTER ITSELF. AND THEY REPRESENT THE CHIEF WEAPON IN THE RAIDER'S ARSENAL.

JOHN KENNETH GALBRAITH, IN A RECENT CHILLING ARTICLE IN THE THE ATLANTIC MONTHLY TITLED "THE 1929 PARALLEL," IN WHICH HE DETAILS HOW LEVERAGING HASTENED "THE GREAT CRASH," PLACED THE AMOUNT OF JUNK BONDS OUTSTANDING TODAY AT $100 BILLION. THAT MAY BE LOW, WHEN JUST ONE FIRM, DREXEL BURNHAM, HAS DONE $16 BILLION IN JUNK BOND FINANCING FOR 64 LEVERAGE DEALS SINCE 1982, AND ANOTHER $10 BILLION FOR OTHER PURPOSES SINCE 1983. IN JUST THE TWO MONTHS AFTER THE IVAN BOESKY SCANDAL BROKE IN NOVEMBER, DREXEL FINANCED AN ADDITIONAL $4 BILLION MORE IN JUNK BONDS. AND THAT'S JUST ONE INVESTMENT BANKING FIRM! SMALL WONDER THE HUMORIST, MARK RUSSELL, HAS SAID INVESTMENT BANKING WAS TO PRODUCTIVE BUSINESS WHAT MUD WRESTLING IS TO THE PERFORMING ARTS.

WHO OWNS THESE JUNK BONDS? THEY ARE NOW EVERYWHERE. IT'S RELIABLY ESTIMATED THAT SOME $6 BILLION ARE IN WEAK SAVINGS AND LOAN INSTITUTIONS THAT NEED THE HIGH INTEREST RATES TO CREATE THE ILLUSION OF GOOD PERFORMANCE. SO, TOO, CAN BILLIONS OF DOLLARS MORE IN JUNK BONDS BE FOUND BEHIND THE PROMISES SOME INSURANCE COMPANIES HAVE MADE TO THOSE WHO HAVE INNOCENTLY PURCHASED THEIR ANNUITIES. THEY ARE, IN SHORT, NOTHING LESS THAN A CREDIT TIME BOMB, ADDING IMMEASURABLY TO THE DANGER ALREADY CREATED FOR THE ECONOMY BY THE MOUNTAIN OF CORPORATE DEBT VOLUNTARILY ASSUMED TO FEND OFF RAIDERS.

THE TIME OF TESTING OF THE REDISCOVERED WONDERS OF LEVERAGE AND THE JUNK BOND IS STILL AHEAD OF US. THEIR POPULARITY HAS COINCIDED WITH AN IMPROVING ECONOMY AND LOWERING INTEREST RATES. BUT AS THE NIGHT FOLLOWS THE DAY, BOTH WILL TURN AROUND, AND THE PIPER WILL BE PAID.

I think it's about time we called these raiders out and took a good look at them in the daylight, the Irwin Jacobs, Saul Steinberg(s), Carl Icahn(s), James Goldsmith(s), Ron Perelman(s), T. Boone Pickens. What great enterprises have they ever managed to success? What have they ever built except their own wealth? What have they ever achieved except financial manipulation? And the same may be asked of their investment banker acolytes.

Who are these superior beings, who as part of their take-over schemes vilify and insult the managements that built the very corporate strengths these raiders intend to sell off, or bury in debt?

For make no mistake, it isn't the poorly-managed, stumbling companies they're after. Quite the opposite. It's companies of the stripe of Phillips Petroleum, Owens Corning, Goodyear, Gulf Oil, ITT. When Chrysler was at the brink, in its darkest hour, its management was safe from the raider's insults.

Bringing it closer to home, my part of the country knows something about the oil business. In 1980 there were 16 major integrated oil companies in the U.S. Thanks to the raiders, 3 have disappeared completely, and 6 others are so heavy with debt they have not room for aggressive research, exploration or development. And what is there to show for the raider's great riches?

This is what Fred Hartley, chairman and president of Unocal Corporation had to say ... "These stock raids and hostile take-overs have not added a barrel of new oil reserves. They have merely shifted them around. They have not inspired one new technology or innovation; they have simply drained off investment capital. They have not strengthened companies, they have weakened them, loading surviving firms with onerous new debt." And what he says about the oil business is true of every other industry that has felt the raider's stained touch.

But it seems, at last, this selling off America with rivers of junk bonds for the private profit of a few is finally beginning to attract the attention of Congress.

And none too soon. Our own Senator Kassebaum has reacted now that a foreign raider, James Goldsmith, chose Goodyear, the most important private employer in Topeka, as his target. Goldsmith failed in his take-over bid, but still made $90 million and recovered all his expenses. T. Boone Pickens reportedly made over $400 million in his failure to acquire Gulf Oil. Small wonder the raiders want no change in the law, it rewards their failures so well.

But the Ivan Boesky affair has opened some eyes, with the exposure of the link between investment banker, raider and arbitrageur, the vast riches taken not as the reward for producing a product or creating new jobs, but through illegal use of information, has taken some of the bloom off the rose.

STATEMENT OF

CLARENCE E. JOHNSON

PRESIDENT AND CHIEF EXECUTIVE OFFICER

BORG-WARNER CORPORATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U.S. SENATE

Washington, D.C.

March 4, 1987

Mr. Chairman and Members of the Committee, I am Red Johnson, President and Chief Executive Officer of the Borg-Warner Corporation. I appreciate the opportunity to appear before the Committee today on the subject of corporate takeovers.

Borg-Warner is a Chicago-based diversified corporation with operations in chemicals, automotive components, protective services and information services.

Our company has a very direct interest in the issue before this Committee. Borg-Warner itself is currently threatened by takeover.

I can't tell you today how this threat will be resolved, but undoubtedly, it will be resolved well before the enactment of any legislation.

The Need for Corporate Takeover and Acquisitions

The public policy issue which brings us together, however, is not corporate takeovers. Corporate mergers and acquisitions are an essential element of our free market.

Acquisitions, whether friendly or hostile, can promote economic efficiency and growth. They help build stronger, more competitive companies and increase shareholder value.

And an unfriendly offer to purchase control of a corporation plays an important role in this process. It allows an acquisition to proceed despite the opposition of recalcitrant management.

The Use of the Hostile Takeover Threat as a Means to Manipulate the Securities Market

Rather, the problem lies with the ability to use stock accumulations, threatened takeovers and leaks to the press to manipulate the market. The rumors, the stories, the threats create massive speculation in a stock like Borg-Warner's with the hope of generating a quick profit, or greenmail.

Seldom do these speculators have any interest in managing the companies they target, and nothing of value is created by their actions. No plants are built; no jobs are created. Instead, huge profits are made overnight and often at the expense of other shareholders and the nation.

The CHAIRMAN. Thank you very much, Mr. Johnson. I thank all of the witnesses. I am deeply impressed and informed by your testimony. I think it's excellent.

GOODYEAR TAKEOVER ATTEMPT

Mr. Mercer, in the takeover attempt against your company by Mr. Goldsmith, you say, as I understand it, that you loaded up with $4 billion in new debt, laid off 4,000 employees, reduced capital spending.

I'm on your side. But critics say that these terminations and the debt is your responsibility. The corporate raiders didn't do it. You made that decision.

How do you justify that?

Mr. MERCER. Fortunately, Senator, we were able to make that decision. The decision we made was to downsize the company by 12 percent rather than allow the raider to take over and downsize it by at least 30 percent.

The CHAIRMAN. Well, how do you know they would have done that? How can you show us that raiders under those circumstances would do that badly?

I understand in the case of TWA that Icahn moved in and some people say saved the company.

Mr. MERCER. Well, of course, there's a whole story on TWA that has to do with a labor contract that was dramatically changed, and if I understand Mr. Icahn, he would like to get out of TWA at this point.

In our case, however, the raider had a track record of busting up companies and in the conversation that I had with him he made it quite clear that he was not interested in running our company but, rather, breaking it up and getting rid of all the pieces. So it was clear what we had to do.

The CHAIRMAN. Now you paid greenmail to him.

Mr. MERCER. We did not, sir.

The CHAIRMAN. $90 million. That was the report in the paper.

> Goldsmith made an estimated pre-tax trading profit of $90 million in his Goodyear stock, the company paying an estimated $30 million to Goldsmith's lawyers and investment bankers.

That's from the Washington Post.

Is that accurate or inaccurate?

Mr. MERCER. Well, fortunately, it was not from Knight-Ridder, Mr. Chapman. I appreciate that.

That is not accurate. We did not pay greenmail. Our classic shareholders have made out better than the raider did and by that definition——

The CHAIRMAN. You paid all the shareholders the same price for the stock that wanted to come in take advantage of it?

Mr. MERCER. We paid them $50 for about 41 percent of their shares and then restructured on the advice that that would take our shares north of $50 and, of course, it hit $56.25 and our raider had to cash in at about $49.50. So he lost out.

The CHAIRMAN. So you are satisfied that it was not greenmail and it's been improperly labeled as greenmail, is that right?

Mr. **Mercer**. We were satisfied before we did it. We had two investment bankers convince us that this would not be greenmail. He said he would not accept it and we said we would not pay greenmail, so we did not.

The **Chairman**. All right. Now one of the reasons I'm raising this is that the Congress is going to outlaw greenmail and poison pills and maybe end up with a situation that's worse for managers as far as takeovers are concerned.

If you can't pay greenmail and you can't use the poison pill, some people say that will dissuade people from getting into the act. On the other hand, it seems to me it takes away your defense. What do we do to balance that?

Mr. **Mercer**. Well, I've got several proposals here. I would certainly outlaw greenmail.

The **Chairman**. You would agree we should outlaw it?

Mr. **Mercer**. We outlawed it. We did not pay greenmail, so we outlawed it ourselves and we recommend respectfully that you outlaw it, that would close that partnership loophole which we think is significant—close that 10-day window, eliminate the tiered tender offers, and extend the minimum tender period to either 40 or 90 market days, and then require the reporting of associated purchases. That would be our recommendation.

The **Chairman**. How about providing a limitation on—do I dare call them junk bonds, How about providing a right of action for the corporation to require tha the raiders use their own money?

Mr. **Mercer**. Senator, we think it would be very important if we turned raiders into true investors, which they are not.

The **Chairman**. Wouldn't that help in doing that?

Mr. **Mercer**. I think it would, yes, sir.

The **Chairman**. Now I've seen one other suggestion that intrigues me and that is that once a group gets 5 percent of the stock of a corporation they would have to hold that stock or any additional amount they got for 5 years and if they sold it in the meantime the profits would accrue to the issuing corporation. Is that too much?

Mr. **Mercer**. Well, I wouldn't buy that. I would think maybe a 6-month period or something of that type. But we're not trying to shut down the classic investor because we do have an operation that's going on in Wall Street that should be preserved, at least the good part of it. But a 5-year limitation I think would be onerous.

The **Chairman**. Senator Sarbanes.

Senator **Sarbanes**. Well, thank you, Mr. Chairman.

First of all, I appreciate the testimony of the panel. It's been very strong and effective. And I'm particularly pleased to see Bob Mercer here, with whom I've had a long association—pleased in one sense, not pleased in another, given the subject matter of the hearing.

Mr. **Mercer**. I understand.

Senator **Sarbanes**. And they have shown a lot of sensitivity to the problem that's been created in Cumberland, MD in our community by this takeover effort by Goldsmith with respect to the Goodyear Tire & Rubber Co. and we're appreciative of that.

I wanted to put a question to the panel generally, if anyone wants to take it on, and that is—everyone sort of says—and it was said by a number of you—that corporate mergers and acquisitions of the proper sort are part of the functioning of the economic system. What we really have here is a fight between the, as I perceive it, the speculators and the producers. I mean, the speculators are moving in at the expense of the producers and the country is suffering as a consequence, management, labor, and the Nation.

DISTINGUISHING PROPER PROPOSALS

Is there some way to distinguish—I mean, most of the proposals are procedural ones directed toward making it more difficult for the takeover artists to move in. In other words, you have to know it sooner, you have more time for the stockholders to consider the tender offer, you lower the stock amount before you can focus on it, but is there some way to go beyond that, that would enable us to distinguish between takeovers that represent an effort to really move in as a producer—in other words, to move into the company and assume the burden of the company on the premise that you can do a better job than the people in there, but your intention is to try to run the company and to do it better than the entrenched management. So you get at this point that you're just defending inefficient or ineffective management.

Is there a way to distinguish between that kind of takeover and the takeover that's for short-term financial gain, as Mr. Mercer says, clearly they have a track record; they were coming in; they were going to take it over, break it up, sell it off, take their profits out and walk away with a lot of money and leave a shambles behind them in terms of a productive enterprise.

This is Mr. Wall's point about whether it's speculation on a stream of basic productive economic enterprise or whether the productive enterprise is simply the bubble on a whirlpool of speculation.

Mr. **Luciano**. Senator, if I may, can I give you an illustration of how we tried to address that at the State level in New Jersey? We passed a law last year which prohibits an acquirer of more than 10 percent of a company who acquired that position without prior negotiation with the incumbent board of directors—we prohibited him after he acquires control of the entire company from getting access to the assets of that company to pay off the debt incurred in the acquisition.

Now he can acquire the company. He can run it better. He can fire the management. But he can't get at the assets and close plants to pay off the debt he incurred to acquire the company.

We thought that was a very rational approach in New Jersey. We, unfortunately, have a sunset provision in that statute so it expires in 1 year and my company, together with the Chamber of Commerce and the AFL-CIO, are now working to make that a permanent piece of legislation.

You can throw out management. You can run the company better. But you can't get at the assets to pay off your debt.

Senator **Sarbanes**. Mr. Chapman.

Mr. CHAPMAN. Senator, that was a suggestion that I included in my abbreviated comments and that is that the target company not be liquidated for 2 years nor any of its assets be used for takeover collateral in that period.

So if someone is an investor and they think they can run the company better and they work it out with a board of directors fine. If they run the company better, fine.

But they can't use those assets for their collateral to support the takeover financing, one; and two they can't liquidate the company for 2 years.

I think if that were involved in national legislation I think you would see a lot of this slow down because many of these people are coming in, and they seek these assets. It takes no great talent to liquidate a company for profit. Anybody can do that. We can do that. But we don't think we're in business to do that.

We think we're in business to maintain a company for a long time. My company was founded in 1907 and I'm proud of the fact that it's grown and I want it to grow 10 years from now and 20 years from now. I could liquidate it and make all of our shareholders a lot richer. I don't want to do that. I don't want some raider to do that.

So if legislation could be provided that would require that they get their financing for an acquisition independent of the assets of a target company, get their financing somewhere else, do not pledge or hypothecate any of those assets, and run that company for a minimum of 2 years before in any way selling off those assets, then I think you will find that a lot of people who have an interest in these takeovers would go somewhere else and do something else.

That's a suggestion that I made that I appreciate the opportunity to elaborate on it.

Mr. LUCIANO. New Jersey's statutory period is 5 years, by the way, but it doesn't differ in any other respect.

Mr. CHAPMAN. Two years would cool them off; 5 years would be better.

Senator SARBANES. Mr. Wall, let me just follow up. Do you have any ideas on what we might do that would kind of rule out of the game what you experienced? In other words, you resisted. They came to you and they had a game plan. They said you could make a lot of money out of this and you showed a commendable sense of responsibility and said that's not——

Mr. WALL. I have high-minded directors that wouldn't have gone along with me.

Senator SARBANES. That's very good, but not everyone does that. Now is there some way that we can, in effect, knock that out of the picture so that they can't play that kind of game and dangle out that possibility and take companies down that path?

Mr. WALL. The technical legal machinery to put in place I think is very difficult at this stage of the game to articulate.

ASPECTS OF RAIDER SUCCESSES

If I could just say one more thing though, and not trying to fudge—I think one of the more infuriating aspects of all of this is not their successes as raiders. It's been the astonishing amount of money that's been made in the failure.

They don't acquire the company. They make $400 million, Mr. Pickens and his cohorts, by not getting Gulf; $90 million by not getting Phillips; Goldsmith, $90 million by not acquiring Goodyear. If we could just put them at hazard so that failure had its price, I think we would go a long way.

I don't think anybody reasonable really wants to stop the acquisition of one company by another. America has been in a continuous state of restructuring. It didn't begin in 1983. All this pious talk about entrenched management and enhancing shareholder value—that existed throughout the entire life of the Republic.

What is new is the hostile raid in the night that pays off even in defeat. It's a fairly recent phenomenon, and its symptoms I think have to be identified and with time a couple of—one, of course, would be to establish absolutely that they had the money, that they were taking a substantial risk, not making offers subject to financing on highly confident letters that are underpinned by huge fees.

I think it goes against the American ethic to see a handful of people make hundreds of millions of dollars over a few weeks of stock manipulation.

Senator **Sarbanes**. Without ever putting themselves at risk.

Mr. **Wall**. Exactly. And even risk is to me an unethical base. You can put yourself at risk in Las Vegas, but it's not something that we laud and support in this country.

What is new, though, is this bare-faced arrogance to pretend that they have this ethical base and they hide behind the pretense that they're going to unhorse privileged management and they're really looking out for the little shareholder. If you believe that, you're just adding gullibility to victimization.

Senator **Sarbanes**. Well, my time is up. Thank you very much.

The **Chairman**. Senator Chiles has come for a very special mission.

STATEMENT OF LAWTON CHILES, U.S. SENATOR FROM THE STATE OF FLORIDA

Senator **Chiles**. Well, thank you, Mr. Chairman.

I understand that the panel has already testified and I know Mr. Chapman and you heard his testimony. He is one of our outstanding citizens. Not only is he chairman of the board and CEO of Knight-Ridder, he is one of the most important forces for social good in our State. In his city he's helped build a lot of bridges between the different ethnic and social groups in Miami, and I know the outstanding work he did in pulling together the community and the citizens against crime. That was a big impetus for a package of legislation that we passed up here.

Whatever the problem has been, from downtown development to helping the State, he's not been so busy with his corporate activities, which are certainly far-reaching, that he hasn't been able to be a citizen.

So I am delighted to have a chance to help present him to the committee. He's already presented himself in the best light by his testimony I know.

The **Chairman**. That was the best second introduction I've ever heard. [Laughter.]

Senator Sasser.

Senator **Sasser**. Thank you very much, Mr. Chairman.

I also want to welcome Mr. Mercer before this committee this morning. We have gone through the takeover crisis with Goodyear in our State and I know what anxieties that created in the community where Goodyear manufactures state-of-the-art auto tires. Frankly, I was delighted to see, through Mr. Mercer's efforts, this takeover attempt being fought off.

Gentlemen, let me play the devil's advocate here for just a moment. Now we've heard testimony from those who espouse the doctrine of the corporate takeover and they say that they only take over those companies that are poorly managed, and only companies that aren't managed well are subject to a hostile takeover.

How would this panel respond to that assertion? Would you like to take a shot at that, Mr. Mercer?

Mr. **Mercer**. Yes, Senator. I would say that history does not bear that statement out. In fact, one of the great examples—I can quote Lee Iacocca who said when he took over Chrysler when it was really on its uppers. He said, "Where were you fellows when I needed you?" They wouldn't even look at Chrysler at that point.

It takes a company that has a strong balance sheet and well-managed and a heavy cash flow that can easily be converted to their own uses that attracts a raider. And many of us in this room and in industry qualify because I think we have done the right job for this country.

Mr. **Luciano**. The takeover, Senator, really occurs, as you well know, at a substantial premium, and the premium has to be repaid in some fashion. There are only a couple of ways you do that. One is by running the company better and there's precious little evidence, as Mr. Mercer has indicated, that anybody has taken over one of these companies and run it better.

The other way of doing it is a way that is within their skill base—namely, asset stripping, highly leveraged debt. That, anybody can do. The question is, what does it contribute to the overall competitiveness of the company, the country, and the welfare of the people who work there?

Senator **Sasser**. Well, gentlemen, let me give you another assertion that many of those who espouse the takeover theory will come up with.

LEANER, MEANER, AND MORE COMPETITIVE

They will say that by their efforts they make corporate America leaner and meaner and more competitive and they will assert that hostile takeovers help allocate resources to higher valued uses and they are helping to restructure corporate America in a very beneficial way.

We have had that testimony right from the table that you're sitting at today. How do you respond to that?

Mr. **Mercer**. Well, again, Senator, they may make us meaner, but we are terribly in debt and that does put a limitation on our future. But right now, the preoccupation at the Goodyear Tire & Rubber Co. is to see if we can pay down $4 billion worth of debt in the next 3 years, and that is a tough assignment.

They have not made the company better. We are going to survive in spite of all of that. That's our challenge.

Senator **Sasser**. Would you like to respond to that, Mr. Chapman?

Mr. **Chapman**. Well, I would just simply support what Mr. Mercer says. All this mountain of debt creates no new jobs. It doesn't do any R&D. It doesn't start any new products and it weakens the economy of this country at a time when we need to be more strongly competitive on a worldwide basis.

You heard Mr. Johnson from Borg-Warner talk about the fact that his company has brought a return to their shareholders of 24 percent. Presumably, that's the compound growth rate. That's a fantastic record and he's one that's under threat right here today.

So they are not going for the bad companies. They are going for companies that have built assets and resources. They want to get their hands on them and what they leave in their wake is a bunch of crippled companies that have got to do their best to survive under conditions that they really shouldn't be forced to be under.

Mr. **Smithburg**. Senator, if I might, I would say that over the last several years, of course, with raiders and many other interested parties, the interest in shareholders and their value and their rights has gotten a lot more attention perhaps than it might have 10, 15 or 20 years ago, and I think there is a good to that and I think that is a real plus.

The real issue I think is the abuses. I don't think any of us would stand before our shareholders if there was a fair offer for the company at a fair price by someone who could manage it or run it as they might perceive better than we or better than anyone else could.

We are today in today's environment, rightfully so for the most part, required to deliver for our shareholders in the near term and required to deliver for our shareholders in the long term, and there is always some balance to that.

Again, I think the issue is, while there has been much good in this attention to shareholders and their rights in our society and it's put a lot of businesses on their toes that might not have been as much on their toes a decade or two ago, it is a matter of the abuses of many of these people that network so well, not in the interest of the country or the company in which they are trying to raid, only in the interest of padding their wallets.

And again back to what I have said in my testimony and the others have said, if we could just get more disclosure, if we could stretch out the tender period so that we could have more time to consider these options in a more fair way, I think we could all do a better job with that level playing field.

Senator **Sasser**. I think Mr. Johnson wanted to respond also a moment ago.

With easy access to credit and limited requirements for disclosure, these speculators can quickly create enough financial leverage to bring some of America's largest corporations to their knees.

Let me explain how the game works.

A small group of individuals -- arbitrageurs, corporate raiders and investment bankers — work together to create market speculation in the stock of certain "targeted" companies. The raiders purchase a large amount of the company's stock, the arbitrageurs create a market in the same stock and feed speculation, and the investment bankers arrange financing, often through the use of low-quality "junk bonds."

Except in rare cases, the objective is not to seek control of the targeted company. Instead, it is to generate a short-run profit for the arbitrageur, greenmail for the raider and client fees for the investment banker.

The market becomes manipulated as these players con other investors into believing that a takeover bid looms. The price moves up in anticipation that a raider is about to pay a premium for control. Yet, that assumption is usually far from the truth.

Once enough market speculation has been created — with all the accompanying pressures on the company — the raider approaches the target for a greenmail payment, attempting to force the company to buy back its stock at a premium to stop the distraction.

If the raider forces a greenmail payment from the company, the stock price drops sharply and other investors, individuals and institutions alike, pick up the pieces. And the targeted company is left with a debt burden that inhibits its future growth and expansion.

If this dangerous trend continues, American business will not retain its competitive position in the world marketplace. Successful companies manage from a long-term perspective, focusing attention on multi-year capital investments and R&D to provide a consistently high return for shareholders.

We at Borg-Warner, for example, have been restructuring the company in a steady evolution that increased the value to shareholders without causing trauma to the organization. Could we have done better than we did? Yes, not everything we tried worked. But we accomplished a great deal.

From 1981 through 1985, before we went into "play," our total return to shareholders, which includes dividends and appreciation, averaged 23.7 percent, compared with 13.7 percent for Standard & Poor's 400. During those same years, we reinvested $1 billion in our businesses in capital expenditures and more than $300 million in research and development.

And we did this without over-leveraging the company.

Yet the current frenzy forces companies in the United States to provide immediate returns for Wall Street, creating a classic "Catch 22" situation. Responding to short-term pressures can result in a higher stock price, but only short term and at the expense of strengthening the business over the long run. American companies will not be able to meet the competitive challenges of the international marketplace unless they are able to focus on capital expansion and R&D.

If this seems blindly repetitive, so be it. It is a message that needs to be repeated.

The Need for Corrective Legislation

Congress needs to pass legislation which will restore balance to the system. Public corporations should produce goods and services, not massive speculation and manipulation. Otherwise, this country will lose its competitive edge and witness an extraordinary transfer of wealth — and with it power -- to Wall Street.

This problem will not be solved by restricting hostile takeovers in their entirety. Instead, Congress must take steps to limit the ability of a few individuals to manipulate the securities markets under the implied threat of a takeover.

Borg-Warner advocates a legislative proposal which strikes a proper balance. The proposal is simple in concept, and it addresses the cause of most, if not all, of the abuses in this area, especially pressures for greenmail. The ideas in this proposal are not new, having been proposed in similar form by others during the last Congress.

The centerpiece of this proposal would require a raider to make a tender offer for all of the targeted company's shares once a threshold level of ownership — say, 10 percent — has been accumulated.

Under existing law, a tender offer is not well-defined and no parameters are established for when a tender offer must be made. Raiders and speculators are free, therefore, to threaten a hostile takeover until the target company provides them with greenmail or another opportunity to sell their shares at a premium not offered to other shareholders.

The proposed bill would eliminate this abuse, while permitting legitimate takeover activity to continue. A conceptual outline of our proposal is attached.

The question of public policy that Congress must address, I submit, is how we as a nation should allocate our capital. Properly, I believe, we should be building plants and funding research, not leveraging our future for the benefit of the few through the debt of manipulation and speculation.

Conclusion

Mr. Chairman, Members of the Committee, thank you once again for the invitation to testify today. Borg-Warner welcomes the opportunity to lend its assistance to this Committee as it considers legislation to solve this important public policy problem.

DISCUSSION DRAFT
2-27-87

S. ________

A bill to eliminate certain abuses in hostile corporate takeovers.

SECTION 1. SHORT TITLE.

This Act may be cited as the "Corporate Takeover Reform Act of 1987".

SECTION 2. FINDINGS.

The Congress finds that—

(1) the current regulatory and investment climate permits a few individuals and institutions to manipulate the stock market to their own financial advantage;

(2) hostile corporate takeovers are being used to create unreasonable speculation in the stock of certain publicly traded companies;

(3) individual shareholders need to receive fair and equal treatment and be protected adequately from abusive takeover practices; and

(4) the activities of arbitrageurs, corporate raiders, and investment bankers should be restricted whenever control of a target company is not the primary objective in a hostile takeover attempt.

SECTIONS 3 and 4. GENERAL PROVISIONS.

A. Limitation on "Creeping" Stock Acquisitions. The purchase of more than ten percent of a target company's stock would have to be accomplished through a formal offer for all outstanding shares. Exemptions would be provided for passive investments and normal stock transfer activities.

Rationale: This provision would restrict unreasonable manipulation of stock prices for the purpose of pressuring a target company into making a greenmail payment. Raiders and arbitrageurs no longer would have any incentive to seek short-run stock profits without any intent or financing to pay a fair price to shareholders for control of a company.

A person or company seeking control of corporate assets would not be restricted from launching a hostile takeover. Control of a company would be sought by offering to pay the same price to each holder of outstanding shares. This provision would codify standard business practice in this area as most corporate acquisitions -- where the purpose is to operate the target company over the long-run — involve an offer or agreement to pay the same price for all the shares.

Two-tiered or partial tender offers would be eliminated by this provision, permitting each shareholder to be treated equally. The incentive for greenmail would be eliminated, and volatility in the public securities markets caused by takeover speculation would be reduced substantially.

This provision also assures compliance with existing tender offer disclosure requirements which widely are being circumvented by takeover entrepreneurs.

The ten-percent threshold was selected to conform to the current statutory provisions of the Hart-Scott-Rodino Act of 1976. Under the Act, premerger notification and waiting period requirements apply to stock acquisitions involving more than $15 million and ten percent of a company's outstanding shares. Until the ten percent threshold is reached, stock acquisitions are presumed to be purchased for investment purposes, and, unless stated otherwise, are exempt from any Hart-Scott-Rodino merger notification requirements. The ten-percent threshold also is the point at which someone becomes a "statutory insider" for purposes of the trading restrictions under §16(b) of the Securities Exchange Act of 1934.

The "creeping" acquisition principle would contain exceptions for stock purchases which result from normal corporate restructuring or clearly are for investment only and not intended to exert special influence over a corporation and its management. For example, acquisitions by or from the company (or by agreement with the company) would be exempt. Additionally, acquisitions by an institutional investor solely for investment purposes (up to fifteen or twenty percent of outstanding shares) would be exempt.

B. Change of Reporting Requirement Threshold. The threshold at which a beneficial owner of securities must report such ownership to the SEC (through a 13(d) filing) would be reduced from five percent to two percent.

Rationale: This provision improves public disclosure of large accumulations of stock: By minimizing the ability of speculators and takeover entrepreneurs to operate in secret, this provision also reduces the likelihood of extensive insider trading abuse as large stock positions are acquired.

C. Elimination of the Ten-Day Window. The period for filing an SEC 13(d) would be reduced from ten days to two days.

Rationale: This measure shortens the time period for public disclosure of a significant stock position in a company in order to further limit short-term market manipulation and secretive transactions involving large stock positions.

RESTRUCTURING FOR THE LAST 5 YEARS

Mr. **Johnson**. Yes, Senator, I did want to respond to that because in our particular case we have been in the process of restructuring for the last 5 years. We have sold off over $500 million worth of assets. We have been repositioning our company, but we have done so in consideration of all of the constituencies we serve.

We not only serve the shareholder, but we serve our customer, we serve our supplier, we serve our employee, we serve our communities and the States where we have plants and physical facilities. And all of these things must be taken into consideration in this restructuring process.

It's underway but it's done out of consideration and that is all part of long-term planning, strategic planning, to rebuild this country and rebuild our industries.

Senator **Sasser**. So, Mr. Johnson, you would not agree with these individuals who espouse hostile takeovers who come in before this committee and testify that they make American industry more competitive internationally, by their efforts they cut the fat and waste out; and by their efforts they make corporate managers pull themselves up by their bootstraps and run a tighter ship?

Mr. **Johnson**. I would have to ask that takeover artist, is it done for the quick dollar, the quick financial return, or is it done out of a strategic plan that is going to create long-term wealth? To me, that's the marked difference.

Mr. **Wall**. Could I add to that? It seems to me that one of the unhappy dividends of this takeover mania has been what is now called the creative use of debt, and a lot of corporate America is beginning to do what the raider would do. That is to say, trade on the equity, use leverage, borrow more and more money. Now that is supposed to provide a discipline. If you're operating a company that's groaning under debt, you don't have money for anything else. All you can do is meet that nut. That's supposed to have a beneficial effect.

But John Kenneth Galbraith wrote a recent illuminating article on this point. He pointed out that we've been able to do this because we're in a period—when leverage has become popular—in declining interest rates and in an increasingly, marginal, economy.

When those turn around, as the day follows the night they will, that's going to be the test of whether we are lean and mean with this huge burden of corporate debt, much of it self-induced to maximize shareholder values and hold off the raiders. If I borrow the money on my own company, there's nothing there for the raider to borrow against so I'm safe.

But one day we're going to have to face up to that and we'll see if that wisdom seems as breathtaking as it does today by Mr. Pickens.

Senator **Sasser**. Gentlemen, my time is up. I thank you. Your testimony has been very helpful today.

The **Chairman**. I would like to follow up on that, Mr. Wall. Isn't it true also that, as Mr. Hartley has said, that he has to pay $3 million every day in servicing his debt because it's gotten so big, and that's $3 million he cannot provide for research and development, $3 million he cannot provide for new equipment that would be more efficient, $3 million he cannot provide for manpower training to improve the skill of his work force. So as a result, that debt is a burden that prevents an improvement in efficiency.

Mr. WALL. Absolutely. And even some of the earlier LBO's are now coming back into the equity market and there are some eyebrows being raised about this leaner, meaner use of debt, they are now coming back and trying to sell stock in those enterprises for more money than they paid when they used the LBO to buy out the stock initially, that raises questions as to just how sincere they were in the first place.

Phillips Petroleum is another good example. That company was restructured on the basis of $20 a barrel oil. That means that's what they have to get to meet the debt and when it goes below that something else has to give, and it isn't all fat.

VULNERABLE WITH A RECESSION

The CHAIRMAN. And throughout the country when we have our corporations much more deeply in debt, in large part—not entirely, but in important part because of this merger mania, it means that they are far more vulnerable come the next recession.

Mr. WALL. I don't think there's any question about that, and add the junk bond on top of that, with weak savings and loans and insurance companies buying them to show short-term good performance, it's a ticking time bomb.

The CHAIRMAN. Mr. Chapman, I got the flavor from your very strong presentation that you never saw a hostile takeover you liked, that there's no such thing as a constructive or positive hostile takeover. And that if people wanted to come in and negotiate with the directors and take over and think they can do a better job and can persuade the directors of that, fine. But I got the impression that, by and large, the hostile takeovers are negative and wrong and we ought to see what we can do legislatively to stop them.

Is that right or wrong?

Mr. CHAPMAN. I support that strongly, Senator.

All of us here support the opportunity for our companies to grow by acquisitions. We have to negotiate those. We have to sit down with the board or with owners and talk with them about how we might do that job better and help operate that company better and it's in their interest to merge with us or to sell to us.

And we do a good bit of that in our company. We've grown a lot that way. But the hostile takeover, where people come in who really don't have the commitment to your business, particularly in our business—we're in communications and we've got assets that are worth a good bit, and if somebody felt they wanted to liquidate those we could potentially be a target. We don't think we are now.

But we would have no objections to sitting down with someone who had the same commitment to our constituents, to our readers, to our advertisers, to our employees, to our communities and to our shareholders, and if they could do that job better and serve all five of those constituencies, we would have no problem sitting down discussing it with them.

The **CHAIRMAN**. Last year I introduced a bill which I didn't push but was supported by the Business Roundtable that would provide that in the event of a hostile takeover it would be necessary to either get the approval of the outside directors or, in order to prevail, you would have to get two-thirds vote of the stockholders in order to win on it.

Now I'm not sure that that is legislation that I should push this time. How do you feel about legislation of that kind?

Mr. **CHAPMAN**. Well, in my testimony—I didn't mention it today because of the constraints of time—I'm suggesting that there be a 15-percent threshold that requires a raider to come to the board and negotiate. If the board turns down the proposal, then there would be an opportunity for the shareholders to vote on it. And my proposal is that the shareholders that would vote would be those that owned the shares on the day before the offer was made, not the arbitrageurs and others that buy later but all the people that have owned the company for a long time and still held their shares, they would vote; and, of course, the takeover artist would vote if he owned the shares as of that date.

But I would propose that there be at least a 51-percent requirement of the shareholders that existed on the day before the offer was announced.

The **CHAIRMAN**. Well, now some people have suggested that it be even longer, that the shareholders who should vote should have 6 months or 1 year or whatever.

Is there anybody on the panel who would favor legislation that would provide for a longer period, that in order to qualify as a voting shareholder you should hold stock for 2 months, 3 months, 6 months, 1 year? Does anybody favor that?

Mr. **LUCIANO**. I indicated in my prepared remarks that I would favor a longer period of time. You would take out the gamesmanship associated with putting a company into play where arbitrageurs and so forth buy in and then—you know how their votes are going to go. The difficulty is coming up with the appropriate period. If you had 90 days, it would seem to be reasonable.

Mr. **CHAPMAN**. I would have no problem with a longer period of time. I suggested the day before, but the further back you move it, the better.

You need to identify those people who have been shareholders in that company for some reasonable period of time who bought it as an investment, who care about the company, who have benefited from owning those shares because they have held it. And they are the ones that should vote and their votes should make the difference as to whether the takeover succeeds or doesn't succeed.

The **CHAIRMAN**. Does anybody disagree with that?

[No response.]

The **CHAIRMAN**. Senator Sarbanes.

Senator **SARBANES**. Mr. Chairman, I just have a couple of comments.

First of all, I think the point that was developed here toward the end of this overhang of corporate debt and what it may mean in an economic downturn is extremely important. What's happening is we're seeing a marked shift in the equity-debt ratio of American corporations. And what that means, of course, in a business cycle, equity rides up and down with the business cycle. That's part of the investment that goes with it. But debt doesn't do that. Debt extracts its toll in any event, no matter how the business cycle is moving.

SKATING ON THIN ICE

And I think if we get a downturn with this corporate overhang, we're headed for some very, very serious problems. We are really skating on thin ice in this regard, in my view.

Let me just put this question to the panel. It seems to me that what all of this does is that, in a sense, the very well-run company, without a lot of debt, with a lot of long-range planning, with a strategic program that in a sense sees it moving from strength from strength, that doesn't necessarily maximize immediate or short-run strength at the cost of long-run strength, is at a disadvantage in this business.

Those are the very companies that these raiders go after. So those are the companies that they go after because they perceive that there's a lot there to pull out.

If they shift the planning to strictly short term, they can move some resources to their advantage.

Let me just put this question. Is it your sense that all of this is forcing American corporations to think very much in the immediate short term at the expense of their long-term strength as an enterprise and, therefore, at the expense of the long-term strength of the economy?

Mr. **Mercer**. There's no question, Senator, that we now listen for footsteps and that will turn us into a short-term operation and it will not help our growth, our international competitiveness for this country and, of course, that will cost us jobs. We simply cannot afford it.

Mr. **Smithburg**. Senator, I would just like to say that there is always a short term and there is always a long term and I think in the last several years the pendulum has swung toward more attention to the short term than I think perhaps is in the best interest of business.

I mentioned in my testimony that a little over a decade ago we had 2 years when our earnings went down and we worked on the problems and we turned them around. The company has prospered over this decade and shareholder value has increased nearly 15 times.

In this environment, it would be very difficult to have 2 bad years, so to speak, without really looking over your shoulder and having to pay a lot of attention to the short term. It's a matter of degree.

But there's always a balance between short term and long term and the balance is generally good.

The Chairman. Thank you very much, gentlemen, for excellent testimony.

The committee will stand adjourned.

[Whereupon, at 1:30 p.m., the hearing was adjourned.]

HOSTILE TAKEOVERS

WEDNESDAY, APRIL 8, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire, (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sanford, Shelby, Graham, Garn, Heinz, D'Amato, Bond, and Chafee.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Mr. Donahue and Mr. Schechter—Mr. Schechter is an old friend of the committee. He's testified many times and I'm delighted to see him. The other gentleman is Mr. David Silberman, the Associate General Counsel of the AFL-CIO.

Welcome to the third in a series of hearings on corporate takeovers and the need for reform.

Today, the subject is the impact of takeovers on employment opportunities.

In 1986, American companies spend $177 billion on takeovers, including $41 billion in hostile deals. That figure of $41 billion is twice the sum spent on all initial public offerings. That $41 billion was 1,300 percent higher than all the venture capital commitments during the year.

Already, most Americans believe corporate takeovers are harmful. According to a nationwide poll by Louis Harris, 58 percent said hostile takeovers do more harm than good. Only 8 percent said hostile takeovers do more good than harm. In fact, a full 67 percent favored legislation to "sharply restrict" takeovers.

We can see who benefits from this mania. Investment banker fees are outrageous. In the Chevron-Gulf merger, investment bankers reaped $63.5 million in fees. Chevron adviser Morgan, Stanley pocketed $16.6 million, while Gulf advisers Salomon Brothers and Merrill Lynch made $30 million and $17 million respectively.

But who pays? Who pays for this takeover mania?

The economic cost of this mania is severe. American corporations sold $263 billion worth of debt in 1986, double the 1985 figure and five times the level in 1982. U.S. corporations may drown in debt. Chevron loaded up with some $2.3 billion in debt.

If these figures are not frightening enough, let us consider some of the personal disasters that beset the American work force. Unemployment, dislocation—these are profound problems.

In 1985, GAF Corp, tangled with Union Carbide. When the dust settled, Union Carbide investment banker Morgan, Stanley was $35 million richer, but Union Carbide was expected to let go some 25,000 of the company's 96,000 employees.

Chevron has laid off some 18,000 employees, with another 12,000 apparently due to be axed.

Baxter Travenol Laboratories, Inc. acquired American Hospital Supply Corp, in 1985, leaving investment bankers $21 million richer, but erasing some 6,000 jobs.

Phillips Petroleum laid off some 7,000 workers after its fight with Boone Pickens.

The Burroughs-Sperry merger, which netted investment bankers some $36 million, resulted in 11,790 job losses.

Some of these numbers are difficult to comprehend. But each unemployed person constitutes a tragedy, a drama of hardship.

American workers are plundered even when they are not terminated. According to the Employee Benefit Research Institute, American firms have terminated more that 1,400 pension plans over the last 6 years in order to skim the surplus off their pension funds for purposes other than paying retired workers. According to Federal statistics, some $12 billion in pension surpluses have been diverted to raiders. Now, Connecticut-based Schick, Inc., which recently acquired Reeves Brothers, is planning to terminate Reeves' pension plan to exploit the surplus funds of $25 million to pay off debt incurred when it bought Reeves. None defend this plan. Not Drexel, which advised Schick on the takeover; not National Westminster, which helped Schick with loans, and not Schick, which declined to respond to a congressional query on the subject.

Raiders often argue that they are the champions of the shareholder. But if shareholders sometimes do profit, where does this profit come from? Gulf shareholders earned a collective $6.5 billion when Chevron bought the company. Did some of this profit come at the expense of the 18,000 workers terminated at Gulf and Chevron? Certainly at least some of these terminations might have come from economic efficiency. But does that account for all the terminations?

Some economists argue that shareholder wealth is only increased through greater efficiencies. Is this true? And are there other dimensions to consider, such as the impact on communities?

Today, we ask labor experts to shed some light on the costs of hostile takeovers.

Senator Garn.

Senator Garn. Thank you, Mr. Chairman. We have a large number of witnesses today, so I will simply ask unanimous consent that my statement be placed in the record.

The Chairman. Without objection, so ordered.

[The complete prepared statement of Senator Garn follows:]

STATEMENT OF SENATOR JAKE GARN

Thank you Mr. Chairman. Today, we hold our third hearing on the subject of corporate takeovers. With the hearings held this year and those conducted by Senator D'Amato in 1985, we will have heard from many, if not all, of the major "stake holders" in this issue.

To date in the 100th Congress, we have heard almost exclusively from the critics of corporate takover activity. I doubt this pattern will change when we hear the testimony today of organized labor.

While there seems to be a consensus of the need for legislation in this area, I again caution that we must not upset the balance between bidders and targets that the Congress has worked to create and preserve. Granted, there have been many takeover abuses in the past few years that should be curbed. However, I remind everyone that many of the companies that have been represented before us, that employ many of today's witnesses' constituents, were formed and made strong through the mergers and acquisitions process.

Again, I welcome this morning's witnesses representing organized labor and I especially look forward to their testimony and hope that it will represent a balanced view of this issue.

The **Chairman**. Senator Sanford.

Senator **Sanford**. No, I think I'll just wait.

The **Chairman**. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, I would like to make a statement, but first I do want to commend you for holding these hearings. The committee has been very thorough in its approach to studying the effects of corporate takeovers, both on the economy and on competitiveness, and today we go beyond the focus on corporate debt, on capital investment, on research and development, and on competitiveness, and shift our level of inquiry to a much more personal one. That is, namely, how takeovers affect employees and the communities.

I might note that we do have a number of very distinguished panels. I am pleased that on one of those panels is a constituent of mine, Mr. James Hatfield, who comes from Media, PA. He's the fellow who's got a bright red tie on and looks quite smashing in it.

The **Chairman**. That's the Wisconsin color. [Laughter.]

Senator **Heinz**. Mr. Chairman, let me say that I think it is fair to say that the wave of merger mania and raider phobia has set the stage for one of the most basic debates we have had in this country in maybe 50 years, and that is, what is the nature of U.S. capitalism?

We have heard from various witnesses that takeovers are good, how they improve efficiency, how they stimulate effective corporate management, how they bolster shareholders' interest, and that's perhaps true in many instances.

But in many other instances I would guess that there are corporate raiders who have very little interest in reform of the executive suite, shareholder advocacy, or more importantly, in the employees of the target, like the famous raider or infamous raider from across the Atlantic, Sir James Goldsmith, who has brought several good-sized companies to their knees, including most recently Goodyear, and I think it's very revealing that Mr. Goldsmith has publicly stated that although "takeovers are for the public good, that's not why I do it," he says. "I do it to make money." Well, he's candid about it.

Somehow, Mr. Chairman, the love of profit under the guise of efficiency and better management gives short shrift to and I think ignores the people issues in corporate takeovers. Now that is not to say that all takeovers, even hostile ones, are undertaken with short-term profit as a primary motive. Whether hostile or friendly, mergers and acquisitions have a human side to them which I don't think we should ignore and, more often than not, the results are unpleasant, ranging from elimination of corporate staff to the closing of a now unnecessary plant and the layoff of its work force.

And beyond that is the impact of takeovers on the entire community. This is particularly true where the community is a company town and the target is the company, witness Bartlesville, OK. I'm not from Bartlesville, OK, mind you, but that town is digging itself out today from the effect of two things. First, the plummeting of oil prices. That didn't finish them. But when Phillips was an attempted takeover of Mesa in 1984, that really did bring both that company and that town to its knees.

In my home State of Pennsylvania, I've seen both the up side and the down side in terms of how acquiring companies have addressed the issue of displaced workers.

Gulf Oil was under attack by a certain gentleman. White knight Chevron appeared on the horizon to save the day and assumed Gulf Oil and its work force. What's happened is Chevron opted to consolidate its operations on the West Coast, closed up shop, and left literally many hundreds of unemployed workers in its wake and Pittsburgh lost one of its three most important corporate headquarters.

I must say, on the other hand, when General Electric—the second largest private employer in Pennsylvania—acquired RCA, it did not put on the block RCA's new Products Division Section in Lancaster, PA. Rather, it permitted those operations to continue until its management team could arrange a private purchase of the division and, although some jobs were lost in the transition, many more were saved. And I might add, a very viable and profitable community employer was saved. So in that instance at least, Mr. Chairman, we have an example of a corporation, GE, that did bring good things to life for the town of Lancaster and, more importantly and more relevantly, its corporate citizenship and ethics should serve as a model for other potential acquirers.

Mr. Chairman, I just wanted to express those thoughts on this subject and I am anxious to hear from our witnesses today.

The **Chairman**. Thank you, Senator Heinz.

Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator **Shelby**. Mr. Chairman, since our last hearing on this subject on March 4, there have been dozens of announced corporate takeovers in America. In the past 34 days alone, corporate takeovers have placed into jeopardy hundreds of thousands of jobs of men and women in America.

During this series of hearings we've been having, we have focused on the impact of corporate takeovers on the economy, productivity, and international competitiveness.

Today, we turn our attention to the very human side of corporate takeovers. I speak to the impact of these takeovers on the innocent employees of the targeted companies, those individuals who have little or no input into the takeover proposal, those employees who after years of loyalty and commitment to a company are left jobless and a lot of times without pension fund benefits.

But by who? By some greedy players on Wall Street. These companies saddled with debt then must take drastic steps to cut costs. Often, the first target of these cuts are the workers. Thousands of jobs will be completely eliminated. Those who are fortunate enough to retain their jobs are faced with the bettersweet reality of substantially lower wages and benefits.

Given the tremendous debt incurred by these companies, I am concerned, Mr. Chairman, that should our economy suffer an economic downturn, thousands upon thousands of more jobs will be lost.

During these hearings, we've heard of the great benefits promised by corporate takeovers and in some cases those benefits have been realized. But, Mr. Chairman, I think we all know to whom the benefit of takeovers go and it is not to the American worker.

The CHAIRMAN. Thank you very much, Senator Shelby.

Senator Graham.

Senator GRAHAM. No opening statement.

The CHAIRMAN. Senators Dixon and Sasser requested that their statements be inserted in the record.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here as the Banking Committee continues its oversight hearings on issues related to corporate takeovers. We have a particularly distinguished group of witnesses from the American Labor Movement before us this morning, including Thomas Donahue, the secretary-treasurer of the AFL–CIO, and I know their testimony will greatly benefit the committee.

At the outset, I would like to make it clear that I share the view of our witnesses today that the takeover area greatly needs reform. All too often, in my view, takeover activity has enriched lawyers, securities companies, those financing the takeovers, and perhaps corporate managements, while substantially weakening the balance sheets of the firms that were taken over, or even threatened with takeovers.

Takeovers can sometimes help improve productivity, but in the recent past, a growing amount of takeover activity seems unrelated to economic fundamentals. Too many companies have been saddled with devastating and unsupportable debt burdens. The results for employees can all too often be layoffs or even a permanent loss of employment. The overall result, in many cases, is a company that is less competitive than before the takeover or threat of takeover occurred.

I do not yet know how best to address this issue, but I do know that we must act—and act quickly. I am inclined to think at the moment, however, that any legislation must include provisions to: one, enhance disclosure and make it more timely; two, ensure that the opportunity for "greenmail" is eliminated; three, provide better protection for company employees and stockholders; four, prevent company managements from protecting themselves through "golden parachutes" and other mechanisms at the company's expense; and five, protect company balance sheets from being encumbered by excessive debt. I was amazed to discover that, in at least some cases, the firms or individuals attempting to take over companies did not have $1 of their own at risk. The stock purchases involved were financed totally with borrowed funds, something that the average purchaser of stock is not allowed to do.

At the same time, we must be careful to strike the proper balance. By restricting undesirable takeover activity, I know the committee does not want to protect incumbent managements who may need to be replaced. Further, it is important to make sure that any action we take is as narrow as possible, in order to minimize interference with the marketplace.

I look forward to hearing from the witnesses before the committee today, and to working with them, my colleagues on the committee, and all interested parties toward developing a strong and workable set of legislative proposals.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. This is the third hearing this committee has held on the subject of corporate takeovers, but in my view it is the most important.

Today, we hear about the cost of takeovers in human terms—the impact on jobs and communities. We already know that the takeover spree has caused an explosion in the amount of corporate debt. Leveraging of our coroporations that could result in bankruptcies when the next recession hits. And we already know, contrary to what many would have you believe, that many efficiently run, well managed companies have been takeover targets. Thus, these companies too are saddled with burdensome debt.

We know who the beneficiaries are: lawyers, investment bankers, select takeover artists, arbitrageurs and those in management who receive golden parachutes.

Who's hurt: companies, communities and employees. The Burroughs-Sperry merger resulted in a company called UNISYS but almost 12,000 lost jobs, many in my home State. The attempted take over of Safeway stores resulted in $150 million being paid in greenmail, another $150 million being paid to lawyers and investment bankers but an estimated 15,000 lost jobs. Goldsmith failed in his attempt to takeover Goodyear but earned $160 million. In response, Goodyear is becoming 12 percent smaller, three plants will be closed and 4,000 jobs lost. The list goes on and on—thousands lose jobs and communities lose their economic mainstays. Indeed, takeover artists don't stop with plant closings and layoffs; they even loot pension funds to pay off the debt they incur in acquisitions.

I'm convinced that this issue requires serious study from the perspective of employees and communities, not just shareholders and management. I'm interested in the comments and proposals of labor in regard to takeovers. I look forward to your testimony.

The **Chairman**. Mr. Donahue, before I call on you, I want to congratulate you on the remarks that were reported from you in the Washington Post this morning on the editorial page.

For the record, I'm going to read just the conclusion of those remarks because I think they are pertinent to this hearing.

You say:

> This is a land of high and chronic unemployment in which at the time of relative prosperity 12 million Americans are wholly or partially unemployed. Year after year, good, useful, well-paying jobs which generations of skilled workers have used to build self-reliant families are being wiped out by attrition or by sudden death of plant closings. In this generation on our watch, millions of young Americans are growing up without the hope of ever in their lives being able to earn their keep, let alone take responsibility for establishing and maintaining families of their own. That's what's wrong with the American family. We can't cure the ills of family life until we cure the ills of work life.

I think that was an excellent statement and I congratulate you on it and go right ahead.

STATEMENT OF THOMAS R. DONAHUE, SECRETARY-TREASURER, AFL-CIO; ACCOMPANIED BY HENRY SCHECHTER AND DAVID SILBERMAN, AFL-CIO

Mr. **Donahue**. Thank you very much, Senator, and thank you for your use of my earlier remarks. Maybe I should let you read this. You do it better than I do. [Laughter.]

We are delighted to be here on behalf of the AFL-CIO and the 13 million people who we represent and are grateful to you for the opportunity to testify on the subject of corporate takeovers and reorganizations, and mostly on their impact on American workers.

You have a full text, Senator, of our statement and I would only like to offer some summary comments of what's contained in that testimony.

As you point out, the events of the past years make it painfully clear that it is the working men and women and their communities who are the ultimate losers in the never-ending series of battles that are being waged for corporate control. So the AFL-CIO strongly supports legislative measures to address the excesses of the present system—the so-called corporate restructuring that is swirling on; that is, going on at an unprecedented rate.

MONOPOLY PLAYED IN FAST FORWARD

I was interested to see—corporate restructuring I think is a dignified phrase. Business Week calls it a 1980's version of Monopoly played in fast forward. And that seems to me an accurate description.

What's happened is just what you have noted, no company, no matter how large or how soundly managed, is safe from the raider or the would-be raider.

This morning's paper notes a hostile bid is dropped at Jenn Corp. and the raider made $75 million to $84 million.

There is a threshold point, Senator, that we would like to make and that is that, we believe there is no economic benefit produced by all of that activity. You've heard the evidence of a number of studies to that effect in this committee and certainly a larger number have been published, and you've heard testimony of the adverse effects on businesses and the threats that are posed by these takeovers to banks, to savings and loans, to pension funds, to insurance companies and so forth.

The point today is to focus on the impact that that corporate restructuring is having on American workers and their communities, and we can tell you that that impact has been severe. In subsequent testimony you will hear the specific instances, instance after instance, in which workers have been victimized by a hostile takeover or a takeover attempt.

Those injuries generally fall into three basic categories. First, the takeovers and takeover attempts have led to the elimination of jobs, often those jobs held by long service employees. It's a sad commentary that there is no comprehensive data available to quantify that job loss. But at a minimum, roughly 80,000 members of unions that are affiliated with the AFL-CIO have been thrown out of work as a direct result of corporate restructuring. And clearly, hundreds of thousands more have been thrown out as an indirect result of those closures and reorganizations.

Business Week estimated over ½ million people have been displaced or, in Business Week's phrase, "asked to take a walk," in the past 3½ years.

The job loss that inevitably adversely affects those workers adversely affects their communities just as much at a time when the community confronts an increasing demand for public services and its tax base is reduced.

Second, corporate reorganizations lead to a reduction of wage and fringe benefits, through raids on pension funds and workers are forced to try to lower their standard of living to get by on less and their retirement income is jeopardized, all in order to finance the employer's acquisitions or restructuring.

Third, by substituting a new employer for a preexisting employer, takeovers destroy seniority and other expectations that employees build up in their jobs over a period of years. New employers are not bound to honor the expectations of those employees and those new employers all too often are ready to take advantage of their power in that regard. And the morale of affected workers goes to an all-time low, all the while they listen to increasing lectures about labor-management cooperation.

In sum, the argument for legislative action could not be clearer. The relevant question it seems to us is not whether to act, but how. There appears to be an emerging consensus for a series of measures designed to provide greater protection to stockholders and to the securities market. So proposals have been advanced before you to tighten the restrictions on insider trading, close the loopholes in regulation G so that it applies to stock purchases financed by junk bonds, amend the Williams Act to provide for at least a fairer auction, and improve shareholder democracy by affording shareholders of the would-be acquirer and the would-be target the right to vote on whether an acquisition should be consummated.

ABOLISH TWO-TIERED OFFERS

The AFL-CIO would support measures of that type and we would especially commend to your attention the proposals to abolish two-tiered offers which we see have clearly a coercive impact and see that as the largest imperfection in the present tender offer system. And we believe it particularly sound to assure the shareholders of acquirers an opportunity to vote on the tender.

There is one further area in which we believe legislative action is called for to protect shareholders in order to avoid collusive sales of assets to incumbent management at fire sale prices. We think that corporate directors who receive an offer from incumbent management for a leveraged buyout ought to be required to secure legal and investment advice from independent professionals, ought to be required to entertain competing offers from outsiders, and to select the offer that is in the best interest of the stockholders and the stakeholders in the company.

In our view, those reforms aimed as they are at solely protecting the stockholders and the securities market are not going to provide a complete or even an adequate response to the present situation. We think the following additional measures are needed.

First, we recommend legislation to prevent those who mount an unsuccessful takeover effort from profiteering from the circumstance that their failed raid has inflated the value of the target stock. The mechanism for achieving that goal is quite simple. Section 16(b) of the Securities Act could be amended to grant targets the right to recover from a raider and those acting with a raider to recover any profit realized from the short-swing sale of stock acquired in connection with a tender offer and sold within a defined period of time after the offer expires or is withdrawn.

EFFECTS OF CORPORATE REORGANIZATION

Second, to protect the communities from the adverse effects of corporate reorganization, two steps ought to be taken. Those mounting a takeover attempt should be required to disclose along with the offer the principal economic assumptions underlying their asset valuation and projections, the sources of and the conditions on the acquirer's financing, the business plans for the target, and any plans of the would-be acquirer with respect to the closing or the sale of any facilities of the target.

In addition, fiduciaries, including most particularly institutional stockholders, called upon to decide how to respond to a takeover, should be permitted to take into account the likely community and social impact of their actions and should not feel legally constrained to maximize their short-term profits and to disregard entirely any longer range or broader interests.

Finally, the AFL-CIO urges enactment of three measures designed specifically to protect workers and other corporate stakeholders from the ravages of corporate reorganization.

First, we believe that contracts voluntarily entered into by a corporation should be binding on the corporate successors or the new owners for the term of those contracts.

Second, acquirers should not be permitted to fund an acquisition or to retire debts assumed in connection with the acquisition by tapping a pension fund and withdrawing the so-called surplus funding from the pension fund.

Third, top managers of an acquired company should not be permitted to escape from a reorganization on golden parachutes at the expense of rank and file workers who are left without any economic cushion whenever their employment is terminated.

Just as employers are currently prohibited from discriminating in favor of high paid employees in paying retirement benefits, so too should they be prohibited from discriminating against those high paid employees in the golden parachute arrangements.

Those proposals, if enacted, would redress at least the most blatant abuses and would not I think unduly interfere with the concerns of some for the so-called "market for corporate control" and would provide a measure of protection for workers, for the communities, and for society at large.

The AFL-CIO therefore would strongly urge this committee to report out a bill which incorporates the measures that I have outlined. Thank you, Mr. Chairman.

[The complete prepared statement of Thomas R. Donahue follows:]

TESTIMONY OF THOMAS R. DONAHUE, SECRETARY-TREASURER, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS ON CORPORATE TAKEOVERS AND REORGANIZATIONS

April 8, 1987

On behalf of the American Federation of Labor and Congress of Industrial Organizations, and the approximately 13,000,000 working men and women represented by the unions affiliated with the AFL-CIO, I welcome this opportunity to testify before this Committee on the subject of corporate takeovers and reorganizations, and their impact on American workers.

I am here for a very simple reason: events of the past few years have made it painfully clear that the actions of raiders, arbitrageurs, and investment bankers have profoundly affected workers and their communities. Indeed, it is the working men and women and their communities who are the ultimate losers in the never-ending series of battles that presently are being waged for corporate control. For that reason, the AFL-CIO and its affiliated unions strongly support legislative measures to address the excesses of the present system.

The Enormous Increase In Corporate Restructurings

There can be no doubt that corporate restructuring -- including hostile takeovers, friendly acquisitions, leveraged buyouts, spin-offs, and recapitalizations -- is going on at an unprecedented rate. Business Week reports that in 1986 alone, American companies spent almost $200 billion in transforming themselves. This is four times the amount spent just three years ago. During the preceding two years, total corporate debt increased by $384 billion -- much of it to finance various forms of acquisitions and reorganizations.

The engine fueling this activity is the hostile takeover attempt. Once a relatively rare event, hostile tender offers have become so routine as to no longer be news; it is estimated that there were at least 400 to 500 such offers in just the past few years.

Moreover, today's hostile takeover is qualitatively different from the takeover attempts of the past. In prior years, tender offers were initiated by financially secure, stable companies desiring to grow or to enter a new market by acquiring and operating some existing business. "What is completely different now," as Business Week puts it, "is that corporate restructuring is completely finance-driven." Today's raiders have neither financial strength nor managerial achievement; they are stock-market operators, and, along with their associated arbitrageurs and investment bankers, are generating deals not because of any desire to operate the target but rather simply to profit from the deal itself. And profit they do. For example, the investment banking firm of Drexel Burnham is estimated to have earned $1.5 billion in profits in 1986 -- close to a 100% return on capital.

Because of these dramatic changes in the hostile takeover field, no company -- no matter how large, or how soundly managed -- is safe from a hostile takeover attempt. Companies like USX and Safeway -- among the 25 largest companies in the United States -- have been recent targets, as have companies like Goodyear and Borg-Warner which are 20-25% more profitable than the average firm in their industry. Thus, as Professor William Frakan of the Harvard Business School observes, every businessman who wishes to avoid becoming a target must constantly ask himself how to "manage the gap between my share price and the breakup estimate of the wildest wide-eyed maniac." The end result is that businesses are being run, and being restructured, not for business results but for protection against the hostile takeover.

Takeovers Do Not Produce Any Economic Benefit

Before discussing in detail the adverse impact of this wave of corporate reorganizations on workers, their communities, and the society at large, I want to first stress one critical, threshold point: in the aggregate, no economic benefit is produced by this activity.

The apologists for takeovers like to cite studies showing that the price of the stock of a target company increases significantly immediately following the announcement of an acquisition or of a takeover attempt. But that fact is hardly surprising; it reflects the market's realization that the acquirer will pay a premium -- or what Peter Drucker more pointedly terms "a bribe" -- to induce the target's stockholders to sell. And that premium or bribe ultimately will have to be paid for out of the assets of the acquirer.

For that reason it is significant that studies of the stock prices of acquiring companies show that within a year after the acquisition, the price of the *acquirer's* stock drops significantly -- by as much as 30%. Yet the apologists generally neglect to mention, let alone attempt to deal with, these studies.

The apologists likewise ignore the results of a second, and even more probative, area of research: studies of the actual success of acquisitions as measured by the performance of acquired and acquiring companies after the acquisition. Professor F. M. Scherer of Swarthmore College and David Ravenscraft of the Federal Trade Commission have recently concluded the most extensive such study yet performed. The Scherer-Ravenscraft paper evaluates the results of nearly 6,000 acquisitions that occurred in the 1960s and early 1970s by analyzing the income statements and balance sheets that, for a period of time, manufacturing corporations were required to submit to the FTC for each of the corporation's distinct lines of business. The data show that on average, the acquired company performed *less well* in the hands of the acquirer than prior to the acquisition, and that the performance of the acquirer was *adversely affected by the acquisition* as well. Of particular relevance to the present situation, Scherer and Ravenscraft found that the 95 hostile takeovers in their study, on average, did not produce any economic benefits to justify the premium paid in the takeover and that, as a result, the ratio of income generated by the acquired unit compared to the costs paid by the acquirer for that unit's assets was far below the overall manufacturing-industry average.

In sum, the available data offer no basis for believing that the incessant rearranging of corporations produces any net economic benefit for the nation. In fact, experience demonstrates that such activity, with its accompanying high levels of debt accumulation, is economically harmful.

The Injuries Inflicted By The Takeover Epidemic

This Committee's hearing record already is replete with evidence of the various harms that the current wave of hostile takeovers, and the resulting wave of reorganizations, has produced. As the Committee has heard, managers today are under inordinate pressure to produce short-term profits and to pay out those profits in the form of high dividends, all at the expense of productive capital investment. As the Committee also has heard, businesses today have assumed unprecedented levels of debt, to the point where 50% of cash flow is now consumed by interest payments; should the economy turn downward, large numbers of businesses will be threatened with failure, and ultimately the viability of those holding the debt -- banks, savings and loan associations, pensions funds, insurance companies and even individuals who have been allured by the high interest rates offered by junk bond mutual funds -- can be jeopardized as well.

The point of today's hearing, however, is not to rehash this evidence, but to focus on the impact that corporate restructuring is having on American workers and their communities. That impact has been severe. You will hear instance after instance in which workers have been victimized by a hostile takeover or takeover attempt. These injuries are of three basic types.

First, takeovers and takeover attempts have led directly to the elimination of jobs -- often those held by long-service employees. No comprehensive data is available to quantify this job loss but, at a minimum, roughly 80,000 jobs of members of unions affiliated with the AFL-CIO were eliminated. This job loss is the direct result of the need of the acquirer -- or of the target which has successfully resisted a raid -- to sell off assets in order to retire some of the heavy debt created by the takeover process. And this job loss inevitably adversely affects the communities in which the jobs were located as each community will confront an increasing demand for public services at the same time that the community's tax base is reduced.

Second, corporate reorganizations lead to a reduction of wages and fringe benefits, and even to raids on pension funds, as workers are forced to lower their standard of living, and their retirement income is jeopardized by the need of their employer to meet the heavy debt service that follows in the wake of a takeover, takeover attempt, or restructuring designed to prevent a takeover attempt from being mounted. Again the workers' harm is felt by everyone in their community who does business with those workers.

Third, by substituting a new employer for a pre-existing employer, takeovers may destroy seniority and other expectations that employees build up in their jobs over a period of years. New employers are not bound to honor the expectations of their employees, and these new employers all too often are ready to take advantage of their power in this regard.

In sum, the adverse impact of corporate reorganizations on working men and women and their communities cannot be denied.

Indeed, it is no exaggeration to say that the only persons who have not been injured by the takeover craze are the raiders (and their associated arbitrageurs and investment bankers) and, in many cases, the top management of the target company. Raiders are generally well-protected: if the raid succeeds, the raider can take over the target company, saddle it with the raider's obligations, and proceed to bust-up the target to meet those obligations; if the raid fails, the raider can rest assured that, one way or another, the target (or a white knight either from outside the target or one formed by the target) will buy off the raider by acquiring his stock at a handsome profit -- a profit that reflects nothing more than the fact that the raider's activities have artificially inflated the value of the stock. And top management is often protected by the so-called "golden parachute" which is not available to lower-level employees who lose their jobs as the result of a corporate restructuring.

The Need For Legislation

The argument for legislative action could not be clearer: huge sums of money are being expended on corporate reorganizations; untold harm is being inflicted on workers, communities, and the economy as a whole; and no offsetting social benefits are being generated by the raiders and their comrades-in-arms who are principally responsible for this situation. The relevant question is not whether to act, but how.

The most obvious need for legislation is with respect to the corrupt practices revealed by the Boesky case and the other cases of insider trading that have followed in its wake. There is an emerging consensus that the restrictions on and the penalties for insider trading should be strengthened. The AFL-CIO joins in supporting such action.

It is far from clear, however, whether the insider trading problem can be effectively dealt with so long as investment bankers, whose business it is to "do deals," and arbitrageurs, whose business it is to trade on deals in the making, work as part of integrated enterprises. Thus, the AFL-CIO believes that serious attention should be given to mandating a divorce between these two functions and these two groups of actors.

Just as a consensus appears to be developing with respect to the need to improve the laws against insider trading, so, too, there seems to be an emerging consensus -- with which the AFL-CIO wholeheartedly concurs -- on the need to protect the proper functioning of securities markets in two other ways.

First, Regulation G, which was promulgated by the Federal Reserve Board to prevent the excessive use of credit for the purchase or carrying of securities, needs to be tightened so that it applies to stock purchases financed by the use of junk bonds. The loopholes in the present regulation have led to precisely the evil which Regulation G was intended to guard against: market inflation driven by the use of borrowed money.

Second, the Williams Act should be amended to improve the tender offer process so as to create a more perfect auction, one that is fairer to stockholders of the target company. Thus, for example, it is generally agreed that stockholders should be notified more quickly of a takeover attempt (by lowering the disclosure threshold and shortening the time period for disclosure); that stockholders should be given a longer period of time to respond to tender offers; and that stockholders should not be coerced into tendering their stock by the fear of being shut-out induced by a two-tiered tender offer. We especially commend to the Committee's attention proposals to prohibit two-tiered offers as we view the coercive impact of such offers to be the largest imperfection in the present tender offer system.

A number of the remaining proposals before the Committee are aimed at enhancing shareholder democracy, either by affording the shareholders of a target operation the opportunity to vote on whether the company should be acquired, by affording the shareholders of acquiring corporations the opportunity to vote on whether their company should acquire another entity, or both. Again, the AFL-CIO joins in supporting these proposals. Given the data showing that acquisitions are dangerous to the health of the acquirer, it seems to us particularly sound to assure the shareholders of acquirers an opportunity to vote on the tender.

There is one further area in which we believe legislative action is called for to protect shareholders, an area which, to our knowledge, has not received a great deal of legislative attention to date: collusive sales of assets to incumbent management. It has become increasingly common for corporate insiders to purchase either a division of "their" corporation or the entire corporation through a leveraged buyout. The potential for sweetheart deals in these circumstances is plain. And that potential has been realized in a number of cases as FORTUNE recently concluded in an article entitled, "Are Shareholders Cheated By LBOs?"

To prevent these abuses, corporate directors who receive an offer from incumbent management for an LBO should be required to deal with that management in an arms-length fashion. In particular, if the directors elect to consider the offer seriously, they should be required to secure legal and investment advice from advisors who are independent of management. The directors also should be required to seek serious competing offers from outsiders, and should select the offer that is in the best interest of the stockholders and stakeholders in the company. And inside directors cannot be allowed to exercise the principal responsibility for this matter because inside directors face an inevitable conflict of interest. These common sense rules -- which several courts recently have endorsed -- merit enactment as positive law.

In our view, however, the foregoing reforms, aimed as they are solely at protecting stockholders and the securities market, would not provide a complete or adequate response to the present situation. We believe that additional measures are needed as well.

Prevent Profiteering By Unsuccessful Raiders

The first additional measure that we recommend to the Committee is one designed to prevent those who mount an unsuccessful takeover effort from profiteering from the circumstance that their failed raid has inflated the value of the target stock. As I previously explained, under the present legal rules even an unsuccessful raider can virtually count on reaping handsome profits from his failure by selling back his stock at inflated prices either to the target company itself or to a "white knight" of one sort or another. This is true even though the profit is generated by speculation on the raid, not by business successes of the target company.

There appears to be a developing consensus that the target company should be prohibited from paying the raider more for his stock than the target is willing to offer all stockholders for their stock across-the-board. Such a rule would, of course, effectively eliminate greenmail as we now know it, and the AFL-CIO endorses such a rule.

But the ultimate evil in greenmail, we submit, is not merely that the raider is favored over other stockholders but that the raider profits from having put the target in play by offering a premium over the market, thereby temporarily inflating the value of the target's stock. A full solution, therefore, is not simply to require that all stockholders receive the same bounty as is granted the raider but to go on to prevent the raider from profiteering from a raid that fails.

The mechanism for achieving this goal is quite simple: a raider, and those acting with the raider as part of his group, should be required to disgorge to the target any profit (less buying and selling expenses) realized from the sale of stock acquired in connection with a tender offer and sold within a defined period of time after the offer expires or is withdrawn. Section 16(b) of the Securities Act of 1934 already authorizes a corporation (or a stockholder suing derivatively on behalf of the corporation) to recover any "short-swing" profits realized by a corporate insider -- including the owner of 10% of the stock of the corporation -- by trading in the stock of the corporation. But under present law, that

right of recovery exists only if the individual was an "insider" both at the time of purchase and sale, and thus applies only to purchases made by a raider after acquiring 10% of the stock and sales made while the raider holds 10%. Furthermore, §16(b) applies only to purchases and sales made within a six month period, a relatively short period of time in the life of a raid. To deal with these deficiencies, §16(b) should be extended to cover all purchases and sales made by a tender offeror (or anyone acting in concert with the offeror) within a one-year period, regardless of the amount of stock the raider owns at the moment of a particular purchase or sale.

Protect Communities From Corporate Reorganizations

Where a corporate reorganization leads to the sale and shutdown of a plant or other facility, the impact on the community in which the facility is located is often profound. It is not possible, of course, to insulate communities fully from these effects which are to some extent inevitable in a world of economic change. But two steps can and should be taken by Congress to ameliorate the community impact.

First, those mounting a takeover attempt (and corporations making self-tender offers) should be required to disclose, along with their offer, the principal economic assumptions underlying their asset valuations and projections, the sources of and conditions on the would-be acquirer's financing, the business plans for the target and any plans of the would-be acquirer with respect to the closing or sale of any facilities of the target. Such disclosure would afford communities advance notice of the likely effects of a takeover, and give the communities an opportunity to avoid or ameliorate the adverse effects.

Second, fiduciaries, including most particularly institutional stockholders, called upon to decide how to respond to a takeover should be permitted to take into account the likely community and social impact of their actions. At present, many fiduciaries feel legally constrained to maximize their short-term profits and to disregard entirely any longer-range or broader interests. Thus, decisions are made which are viewed, even by the decision-makers themselves, as unwise but as compelled by fiduciary obligations. Legislative action is needed to permit fiduciaries to consider, if they wish, a broader range of interests.

Protecting Workers and Other Stakeholders

Finally, the AFL-CIO urges enactment of three measures designed specifically to protect workers, and other corporate stakeholders, from the ravages of corporate reorganizations.

First, contracts voluntarily entered into by a corporation should be binding on the corporate successors or new owners for the term of such contracts. This rule should apply to contracts with suppliers, purchasers, creditors, debtors and, most particularly, workers. To allow such pre-existing contracts to be ignored if a reorganization occurs, incites restructuring for the sole purpose of reaping whatever gains can be achieved from breaching contractual commitments. A society that believes in the sanctity of contracts should not tolerate such incentives.

Second, acquirers should not be permitted to fund an acquisition (or to retire debts assumed in connection with the acquisition) by tapping a pension fund and withdrawing so-called surplus funding from the fund. While the AFL-CIO generally believes that the assets of a pension fund represent deferred compensation of the workers which belongs to the workers and thus should be out of the reach of any employer, at the very least it is clear that employers should not be compelled to keep pension trusts funded at a minimum level. Yet employers are today forced to do just that because an "overfunded plan" is raw meat for a would-be raider. To prevent the reorganization epidemic from infecting the pension system, acquirers should be precluded from using pension fund assets to finance an acquisition.

Third and finally, top managers of an acquired company should not be permitted to escape from a reorganization on golden parachutes at the expense of rank-and-file workers whose employment is also terminated. Just as employers are, at present, prohibited from discriminating in favor of highly-compensated employees in paying retirement benefits, employers should likewise be prohibited from engaging in such discrimination with respect to contingent severance benefits, such as those provided by a golden parachute agreement.

Conclusion

The proposals we advocate are not panaceas which will cure all of the evils of the current wave of corporate restructuring. But these proposals, if enacted, will redress at least the most blatant abuses and will, without unduly interfering with the so-called "market for corporate control," provide minimal protection to workers, their communities, and the society-at-large. The AFL-CIO therefore strongly urges this Committee to report out a bill which incorporates the measures set forth above.

The CHAIRMAN. Thank you very much, Mr. Donahue.

I'm going to call on Senator D'Amato who has an opening statement before we get into the question period.

Senator D'AMATO. Thank you very much, Mr. Chairman.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I'm going to abbreviate my statement but I would like to emphasize several points contained in my remarks.

After reviewing much of the testimony that was submitted by the witnesses, I was glad to see that S. 227, the Tender Offer Reform Act of 1987, which I introduced on January 6, 1987, incorporated many of the legislative recommendations offered by our witnesses today.

While S. 227 differs with some of the specific recommendations contained in this morning's testimony, the bill still addresses the legitimate concerns expressed by the witnesses.

Specifically, this morning's witnesses have urged us:

(1) To restrict the payment of greenmail. S. 227 does this.

(2) Restrict the award of golden parachutes. S. 227 does this.

(3) Require bidders to disclose more information about the impact of a takeover on the target company and its employees. S. 227 does this.

(4) Require the disclosure of information concerning the terms and conditions of tender offers in a manner that shareholders can understand. S. 227 does this.

(5) Close the 10 day window of section 13(d) and require an immediate public announcement when a purchaser reaches a 5-percent threshold requiring a Schedule 13(d) filing. S. 227 does this.

(6) Increase the minimum offering period in a manner that is also designed to discourage partial and two-tiered tender offers. S. 227 does this.

(7) Eliminate the practice known as "sweeping the street." S. 227 does this.

(8) Tighten the meaning of the term "group." S. 227 does this.

Now I have tried since December 1985, contrary to some statements made by some of my colleagues, Mr. Chairman, to bring the various corporate constituencies to the bargaining table to enact comprehensive tender offer reform.

Apparently these efforts have not been in vain. Those who have closely followed this debate should note the number of similarities between the proposals offered this morning, the proposals recently announced by the securities industry, the proposals advocated by the business community, and the provisions of S. 227.

The corporate takeover hearings we have had in this Congress and in the last Congress have been useful in identifying the abuses which must be corrected. We have had sufficient time to analyze the problem. The time has come to consider seriously specific legislative proposals, and our failures to consider these proposals in the near future will severely jeopardize our ability to have a tender offer bill signed into law by the end of this year.

So my colleagues may familiarize themselves with the provisions of S. 227, Mr. Chairman, I ask unanimous consent that a copy of that bill and my introductory remarks be included in the record after my statement, and also that some of my additional materials be included in the record at the appropriate location.

Mr. CHAIRMAN. Without objection, so ordered.

Senator D'AMATO. Thank you, Mr. Chairman.

[The complete prepared statement of Senator D'Amato, proposed bill S. 227, and statement from the Congressional Record, dated January 6, 1987, follow:]

100TH CONGRESS
1ST SESSION

S. 227

To amend the Securities Exchange Act of 1934 to impose additional restraints on corporate tender offers, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JANUARY 6, 1987

Mr. D'AMATO introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 to impose additional restraints on corporate tender offers, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as the "Tender Offer Reform Act of 1987".

SEC. 2. (a) Section 13(d)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(d)(1)) is amended—

(1) by striking out "shall, within ten days after such acquisition, send" and inserting in lieu thereof "shall cease to acquire additional shares of such class until the expiration of two business days after such ac-

quisition (or such shorter period as the Commission may prescribe pursuant to paragraph (7)), and shall, within twenty-four hours after such acquisition, make a public announcement of such acquisition and send"; and

(2) by adding at the end thereof the following:

"The public announcement required to be made within twenty-four hours of an acquisition described in this paragraph shall include disclosure of the purchaser's identity, the amount of securities of the class beneficially owned by the purchaser, the identity of the issuer of that class, a brief description of the purpose of such acquisition, and other information that the Commission may prescribe by rule, regulation, or order.".

(b) Section 13(d) of the Securities Exchange Act of 1934 is further amended by adding at the end thereof the following new paragraph:

"(7) The Commission, by rule, regulation, or order, in the public interest or for the protection of investors and taking into account the time required for the information filed to be properly disseminated, may reduce the time period during which any person subject to the requirements of paragraph (1) of this subsection is prohibited from acquiring ownership of any additional shares of the equity security that is the subject of the statement required by paragraph (1) and may, subject to such terms and conditions as may be prescribed therein, provide exemptions from that prohibition.".

SEC. 3. (a) Section 13(d)(3) of the Securities Exchange Act of 1934 is amended by inserting "voting," after "acquiring,".

(b) Section 13(g)(3) of the Securities Exchange Act of 1934 is amended by inserting "voting," after "acquiring,".

SEC. 4. (a) Section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) is amended—

(1) by striking out the heading of such section and inserting in lieu thereof the following:

"PROXIES AND TENDER OFFERS";

(2) by inserting "(A)" after "(1)" in subsection (d);

(3) by adding at the end of paragraph (1) of subsection (d) the following:

"(B) The person making an offer, request, or invitation subject to this paragraph shall prepare and furnish to security holders at the time the offer, request, or invitation is published, sent, or given to security holders a summary disclosure of—

"(i) the identity and background of such person and any affiliates or associates of that person participating in the offer, request, or invitation;

"(ii) the value of the offer, request, or invitation;

"(iii) the amount of such securities beneficially owned by the persons identified under clause (i);

"(iv) the source and amount of funds or other consideration used for the proposed acquisition of securities;

"(v) the purpose of the acquisition;

"(vi) any plans or proposals the person has regarding the future operations or structure of the issuer; and

"(vii) such additional information as the Commission may, by rule or regulation, prescribe as necessary in the public interest or for the protection of investors.

Such person shall make a public announcement if the person varies any of the terms required to be disclosed under this subparagraph before the expiration of the offer, request, or invitation.

"(C) The Commission may adopt such rules, regulations, and orders as may be necessary or appropriate in the public interest or for the protection of investors to—

"(i) implement the provisions or carry out the purposes of this paragraph;

"(ii) to define any term used in this paragraph;

"(iii) to exempt any person or transaction or class of persons or transactions, as not comprehended within the purposes of this paragraph, in whole or in part, either unconditionally or upon specific terms and conditions; or

"(iv) to prevent any person from evading or circumventing the provisions of this paragraph.";

(4) by striking out paragraphs (2) and (3) of subsection (d), by redesignating paragraph (4) of such subsection as paragraph (2), and by inserting after such redesignated paragraph (2) the following new paragraph:

"(3)(A) Any person making a tender offer for or a request or invitation for tenders of any and all of the outstanding shares of a class of voting securities shall hold such offer, request, or invitation open for a period of at least 30 calendar days from the date on which such offer, request, or invitation is first published, sent, or given to security holders. Any person making a subsequent tender offer, request, or invitation for tenders for any and all or less than all of the outstanding shares during the pendency of another tender offer, request, or invitation for tenders under this paragraph with respect to any of such shares shall hold such offer, request, or invitation open for a period of at least 20 calendar days except that the subsequent offer, request, or invitation shall not terminate before the 30th calendar day following the initial offer.

Alfonse D'Amato

STATEMENT OF SENATOR ALFONSE M. D'AMATO

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

APRIL 8, 1987

THE MEMBERS OF THIS COMMITTEE AND THE WITNESSES APPEARING THIS MORNING ARE ALL AWARE OF MY FERVENT DESIRE TO ENACT TENDER OFFER REFORM LEGISLATION THIS YEAR. MY GOAL IN INTRODUCING A COMPREHENSIVE TENDER OFFER REFORM PACKAGE IN THE 99TH CONGRESS AND AGAIN IN THE 100TH CONGRESS WAS AND IS TO DISCOURAGE PURE FINANCIAL PLAYS AND GREENMAIL WHILE RESTORING THE BALANCE BETWEEN BIDDERS AND TARGET CORPORATIONS. THE LEGISLATION I HAVE INTRODUCED IS ALSO DESIGNED TO SATISFY THE PRIMARY PURPOSE OF THE WILLIAMS ACT -- THE PROTECTION OF SHAREHOLDERS AFFECTED BY CORPORATE TAKEOVERS.

AFTER REVIEWING MUCH OF THIS MORNING'S TESTIMONY, I WAS GLAD TO SEE THAT S.227, THE TENDER OFFER ACT OF 1987 WHICH I INTRODUCED ON JANUARY 16, 1987, INCORPORATES MANY OF THE LEGISLATIVE RECOMMENDATIONS OFFERED BY OUR WITNESSES. WHERE S.227 DIFFERS FROM SPECIFIC RECOMMENDATIONS CONTAINED IN THE MORNING'S TESTIMONY, THE BILL STILL ATTEMPTS TO ADDRESS THEIR LEGITIMATE CONCERNS.

SPECIFICALLY, THIS MORNING'S WITNESSES HAVE URGED US TO:

(1) RESTRICT THE PAYMENT OF GREENMAIL - S.227 DOES THIS;

(2) RESTRICT THE AWARD OF GOLDEN PARACHUTES - S.227 DOES THIS;

(3) REQUIRE BIDDERS TO DISCLOSE MORE INFORMATION ABOUT THE IMPACT OF A TAKEOVER ON THE TARGET COMPANY AND ITS EMPLOYEES - S.227 DOES THIS;

(4) REQUIRE THE DISCLOSURE OF INFORMATION CONCERNING THE TERMS AND CONDITIONS OF TENDER OFFER IN A MANNER THAT SHAREHOLDERS CAN UNDERSTAND - S.227 DOES THIS;

(5) CLOSE THE 10 DAY WINDOW OF SECTION 13D AND REQUIRE AN IMMEDIATE PUBLIC ANNOUNCEMENT WHEN A PURCHASER REACHES THE 5% THRESHOLD REQUIRING A SCHEDULE 13D FILING - S.227 DOES THIS;

(6) INCREASE THE MINIMUM OFFERING PERIOD IN A MANNER THAT IS ALSO DESIGNED TO DISCOURAGE PARTIAL AND TWO-TIER TENDER OFFERS - S. 227 DOES THIS;

(7) ELIMINATE THE PRACTICE KNOWN AS SWEEPING THE STREET - S. 227 DOES THIS; AND

(8) TIGHTEN THE MEANING OF THE THE TERM "GROUP" - S. 227 DOES THIS.

I HAVE TRIED SINCE DECEMBER OF 1985 TO BRING THE VARIOUS CORPORATE CONSTITUENCIES TO THE BARGAINING TABLE TO ENACT COMPREHENSIVE TENDER OFFER REFORM. APPARENTLY, THESE EFFORTS HAVE NOT BEEN IN VAIN. THOSE WHO HAVE CLOSELY FOLLOWED THIS DEBATE SHOULD NOTE THE NUMBER OF SIMILARITIES BETWEEN THE PROPOSALS OFFERED THIS MORNING, THE PROPOSALS RECENTLY ANNOUNCED BY THE SECURITIES INDUSTRY, THE PROPOSALS ADVOCATED BY THE BUSINESS COMMUNITY AND THE PROVISIONS OF S. 227.

THE CORPORATE TAKEOVER HEARINGS WE HAVE HAD IN THIS CONGRESS AND THE LAST HAVE BEEN USEFUL IN IDENTIFYING THE ABUSES WHICH MUST BE CORRECTED. WE HAVE HAD SUFFICIENT TIME TO ANALYZE THE PROBLEM. THE TIME HAS COME TO CONSIDER SERIOUSLY SPECIFIC LEGISLATIVE PROPOSALS. OUR FAILURE TO CONSIDER THESE PROPOSALS IN THE NEAR FUTURE WILL SEVERELY JEOPARDIZE OUR ABILITY TO HAVE A TENDER OFFER REFORM BILL SIGNED INTO LAW BY THE END OF THIS YEAR.

SO MY COLLEAGUES MAY FAMILIARIZE THEMSELVES WITH THE PROVISIONS OF S.227, I ASK UNANIMOUS CONSENT THAT A COPY OF THE BILL AND MY INTRODUCTORY REMARKS BE INCLUDED IN THE RECORD AFTER MY STATEMENT. I ALSO ASK THAT SOME ADDITIONAL MATERIALS BE INDLUDED IN THE RECORD AT THE APPROPRIATE LOCATION.

"(B) Any person making a tender offer or request or invitation for tenders for less than all the outstanding shares of a class of voting securities shall hold such offer, request, or invitation open for a period of at least 40 calendar days from the date on which such offer, request, or invitation is first published or sent or given to security holders. Any person making a subsequent tender offer, request, or invitation for tenders for any and all or less than all of the outstanding shares during the pendency of another tender offer, request, or invitation for tenders under this paragraph with respect to any of such shares shall hold such offer, request, or invitation open for a period of at least 30 calendar days, except that the subsequent offer, request, or invitation shall not terminate before the 40th calendar day following the initial offer, request, or invitation.";

(5) by redesignating paragraphs (5) through (8) of such subsection as paragraphs (4) through (7), respectively;

(6) by redesignating subsections (f) and (g) as subsections (k) and (l), respectively; and

(7) by inserting after subsection (e) the following new subsections:

"(f) During a tender offer for, or request or invitation for tenders of, any class of any equity security which is registered pursuant to section 12 of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940, other than an offer, request, or invitation by the issuer, it shall be unlawful for the issuer of such securities to enter into or amend, directly or indirectly, agreements containing provisions, whether or not dependent on the occurrence of any event or contingency, that increase, directly or indirectly, the current or future compensation of any officer or director, except that this provision shall not prohibit routine increases in compensation, or other routine compensation agreements, undertaken in the ordinary course of the issuer's business.

"(g) It shall be unlawful for an issuer to purchase, directly or indirectly, any of its securities at a price above the average market price of such securities during the 30 preceding trading days from any person who holds more than 5 percent of the class of the securities to be purchased and has held such securities for less than 6 months, unless such purchase has been approved by the affirmative vote of a majority of the aggregate voting securities of the issuer, or the issuer makes an offer to acquire, of at least equal value, to all holders of securities of such class and to all holders of any class into which such securities may be converted.

"(h) The Commission may, by rule, regulation, or order, in the public interest or for the protection of investors, provide exemptions, subject to such terms and conditions as may be prescribed therein, from any or all of the provisions of subsection (f) or (g).

"(i)(1) During any 12-month period beginning on the date on which a person first acquires beneficial ownership of 20 percent of a class of (A) equity securities of a corporation which is registered pursuant to section 12 of this title, (B) equities security of an insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of this title, or (C) equities security issued by a closed-end investment company registered under the Investment Company Act of 1940, or during any succeeding 12-month period, it shall be unlawful for any person to acquire, directly or indirectly, beneficial ownership of more than 2 percent of the outstanding shares of such a class of securities except by tender offer or request or invitation for tenders or by purchase from the issuer.

"(2) Paragraph (1) does not apply in any case where—

"(A) the acquisition is involuntary, including any acquisition by gift, inheritance, or bequest, or by such similar transaction as the Commission may, by rule, regulation, or order, prescribe;

"(B) the acquisition is pursuant to a statutory merger or consolidation consummated under the laws of the issuer's state of incorporation; or

"(C) the Commission, by rule or regulation, or by order upon application, conditionally or unconditionally exempts any person, security, or transaction, or any class or classes of persons, securities, or transactions, from the provisions of this subsection and any regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest and consistent with protection of investors and purposes fairly intended by the policy and provisions of this subsection.

"(3) In determining, for purposes of this subsection, any percentage of a class of any security, section 13(d)(3) shall apply and any person, in determining the amount of outstanding securities of a class of equity securities, may rely upon information set forth in the issuer's most recent report filed with the Commission pursuant to this Act which contains information concerning the amount of outstanding securities of such class of securities.

"(4) For purposes of paragraph (1), a person will not be deemed to beneficially own securities by virtue of participating in a syndicate or group formed for the purpose of the solicitation of any proxy, consent, or authorization pursuant to subsection (a).".

(b) Such section is further amended by adding at the end thereof the following:

"(j)(1) When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, voting, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for purposes of subsections (d), (e), (f), (g), and (i) of this section.

"(2) For purposes of subsections (d), (g), and (i) of this section, in determining any percentage of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer or any subsidiary of the issuer.".

SEC. 5. None of the amendments made by this Act shall be construed to limit or condition the authority of the Securities and Exchange Commission, in the public interest or for the protection of investors, to supplement the proration, withdrawal, and minimum offering periods applicable to a tender offer or request or invitation for tenders.

SEC. 6. (a) The Comptroller General, in coordination and consultation with the Securities and Exchange Commission, the Federal Home Loan Bank Board, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Savings and Loan Insurance Corporation, the Federal Deposit Insurance Corporation, the

Secretary of the Treasury, and the Secretary of Labor shall study the issuance of and investment in high yield, noninvestment grade bonds during the 5 years prior to the date of enactment of this Act, including—

(1) the identity and rating (as determined by Moody's, Standard and Poor's, or other nationally recognized bond rating house) of the issuers of these bonds;

(2) the identity of the major purchasers of these bonds, including but not limited to federally insured depository institutions;

(3) the percentage of the total amount of high yield, noninvestment grade bonds that are issued as a method of financing corporate takeovers;

(4) the identity of the purchasers including, but not limited to, federally insured depository institutions that invest in high yield, noninvestment grade bonds that are issued as a method of financing corporate takeovers;

(5) the purposes for which high yield, noninvestment grade bonds are issued other than for financing corporate takeovers;

(6) a summary and analysis of the adequacy of current State and Federal laws that regulate investment in high yield, noninvestment grade bonds, by in-

vestors including, but not limited to, federally insured depository institutions and pension funds; and

(7) a review of the impact of the issuance of and investment in high yield, noninvestment grade bonds upon corporate debt as it relates to Federal monetary policy.

(b) In addition to the collection of information through surveys, public document review, interviews, and other information-gathering methods, at least one joint public hearing shall be held during the course of conducting the study.

(c) The Comptroller General shall transmit a report containing the results of the study under this section to the Congress not later than 120 days after the date of enactment of this Act.

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By Mr. D'AMATO:

S. 227. A bill to amend the Securities Exchange Act of 1934 to impose additional restraints on corporate tender offers, and for other purposes; to the Committee on Banking, Housing, and Urban Affairs.

INTRODUCING THE TENDER OFFER REFORM ACT OF 1987

Mr. D'AMATO. Mr. President, in the weeks subsequent to the revelation of the Ivan Boesky insider trading scandal, many of my colleagues have been advocating reforms of the laws governing corporate takeover activity. I applaud my colleagues for their interest in this area of the law because I have also been advocating amendments to the Williams Act. In fact, I have been advocating for reform of the Federal securities laws governing corporate takeovers for several years. I regret that it took an event as tragic as the Boesky scandal to bring to the attention of many of my colleagues the need for amendments to the Williams Act.

Today I am introducing three proposals that will amend the Securities Exchange Act of 1934 ("Exchange Act"). The proposals could have easily been combined into one legislative package. The first legislative proposal addresses the issues attendant to the laws governing corporate takeovers. The second and third proposals address issues attendant to insider trading. I have chosen to introduce them separately to emphasize the differences between reform of the laws governing corporate takeovers and reform of the laws prohibiting insider trading.

Such a distinction is required because many commentators have cited the Boesky scandal as the justification for drastic reform of the laws governing corporate takeovers. In drafting responsible legislation addressing the abuses of insider trading and certain abusive practices employed in contests for corporate control takeovers—especially hostile takeovers, I think that a distinction must be made between those who trade on inside information in the context of takeovers and those who engage in conduct which contravenes the Williams Act. Therefore, I have introduced separate legislative proposals which are designed to remedy separate deficiencies in the securities laws.

Students of tender offer reform should recognize the legislation which I introduce today because it is almost identical to the legislation (S. 1907, The Tender Offer Reform Act of 1985) which I introduced on December 6, 1985. Although this legislation received little notice from my colleagues (except those colleagues who have subsequently introduced proposals similar to those contained in S. 1907) at the time of its introduction, it received much favorable comment from members of the securities bar advocating amendments to the Williams Act. It was also the only piece of comprehensive tender offer reform legislation introduced in either body during the 99th Congress. Furthermore, it addresses many, if not all, of the concerns recently expressed by my colleagues regarding the regulation of corporate takeover activity. For example, it limits the practice of greenmail and the payment of golden parachutes; it makes it more difficult for corporate raiders to engage in two-tier and partial takeovers; it requires those acquiring 5 percent or more of a companies' stock to announce almost immediately their position in a particular security; it provides for simplified disclosure of the terms and conditions of a takeover to shareholders; and it restricts the usage of unconventional tender offers which have been undertaken in a deliberate attempt to avoid the requirements of the Williams Act. The purpose of this legislation is to further the original goals of the Williams Act by increasing shareholder protection while maintaining the balance between bidders and targets which the authors of the Williams Act desired to create.

The one substantive change to this bill as introduced last year is the deletion of the provision which prohibited the use of discriminatory tender offers such as that employed by Unocal Corporation. This provision has not been included because the SEC has promulgated a rule, commonly referred to as the all-holders rule, that accomplishes the purposes of that provision of my previous legislative proposal.

This bill does not include provisions previously contained in section 4(a)(7)(i) of S. 1907. That section would have required that tender offers be made to all shareholders equally: all shareholders would have to be included in a tender offer, and all shareholders would receive compensation at the same level. This section is no longer necessary because the Securities and Exchange Commission apparently recognized the wisdom of adopting a provision similar to section 4(a)(7)(i) and utilized its rulemaking power under the Securities Exchange Act of 1934 to adopt rules providing for these same protections; amended rule 13e-4(f) now provides "all holders" and "best price" safeguards for tender offers by issuers, and new Rule 14d-10 provides such requirements for third party tender offers.

The Exchange Act provides authority for the Commission to adopt these safeguards. For example, under section 23(a), the Commission is authorized to adopt rules necessary or appropriate to implement the provisions of that act. The new all holders and best price provisions are in furtherance of the purposes of the Williams Act amendments to the Exchange Act, adopted in part to eliminate discriminatory treatment among security holders who may desire to tender their shares. With clear agency rulemaking, there no longer is any need for legislative action on these points.

The Tender Offer Reform Act of 1987 provides a comprehensive legislative response to the issues raised in the public debate on corporate takeover activity This debate has been waged in earnest in Congress, the courts, corporate boardrooms, and the SEC in recent years. The legislation addresses the many issues that have arisen from the increase in corporate takeover activity in the last 4 years. I would hope that my colleagues will take a keen interest in tender offer reform during the Committee's examination of the issue of tender offer reform, this bill and other legislative proposals which undoubtedly will be introduced.

Within the last few years, contests for corporate control have become a more frequent phenomena on the American business scene. Once the private domain of a handful of investment bankers, lawyers, and corporate executives, takeover contests have become an increasingly popular spectator sport. The publicity surrounding several recent multi-billion dollar acquisitions has familiarized the public with a glossary of new terms including, among others, golden parachutes, greenmail, bear hugs, shark repellent, poison pills, pac man defense, scorched earth defense, lock ups, leg ups, silver wheel chairs, crown jewels, and white knights. These terms have been used to describe the various offensive and defensive tactics which may be employed to effectuate or prevent a change in corporate control.

Contests for corporate control have been conducted with the intensity of military campaigns, with the futures of large and small companies and the economies of affected communities hanging in the balance. Elaborate strategies and ingenious tactics have been developed to facilitate takeover attempts and to defend against them. Skirmishes are fought in company boardrooms, in shareholders' meetings and, with increasing regularity, in the courts.

The "problems" attendant to takeovers are in the forefront of corporate law and have spawned much congressional inquiry. As chairman of the Securities Subcommittee of the Senate Banking Committee, I conducted hearings on the long-term effects of takeover activity on the credit and capital markets. The adequacy of the existing Federal regulation of the takeover process, the Williams Act, in maintaining a balance between acquiring and target companies was also examined. Although the hearings were held on April 3 and 4, and June 6 and 12, 1985, (See, S. Hrg. 99-187), I have continued to expend considerable effort to develop an appropriate legislative response to the issues raised during those hearings and to the issues presented by recent court decisions affecting the application of the Williams Act.

During the subcommittee's hearings and throughout its subsequent inquiry, the complexities attendant to the regulation of battles for corporate control have become apparent. For example, a tremendous divergence of opinion exists with regard to the threshold question: Is the Williams Act working? Some contend that Congress is compelled to act because the abusive tactics employed by raiders and defenders demonstrate a breakdown in the rules that govern corporate takeover activity. Others contend that the Williams Act is functioning properly and that few, if any, changes are needed.

In devising an appropriate legislative response, several issues must be addressed. Foremost among them is determining the causes of the current increase in takeover activity and whether the causes are amendable to legislative solutions. In testimony received by the subcommittee, the increase in takeover activity has been attributed to the depressed value of a target's stock price caused by international competition, a relatively strong dollar, fluctuating interest rates, and declining rates of inflation; economic forces that have driven the restructuring of many U.S. industries rendering them susceptible to takeover; the availability of credit to finance these transactions; the prevailing legal and business climate that permits combinations to take place with little risk of Government interference; and the advantages in the Tax Code that subsidizes debt over equity, thus encouraging the use of debt financing for acquisitions. If these are the causes of the recent increase in takeover activity, then amending the securities laws will not necessarily provide an appropriate legislative response.

Another possible solution would be to regulate the various offensive and defensive tactics employed in struggles for corporate control. There are numerous reasons why Congress should not attempt to ban specific tactics. Congressional prohibitions which preclude management from engaging in certain activities interject the Federal Government into the corporate decisionmaking process. Congress should be wary of needless intrusions into corporate boardrooms where it neither should feel comfortable, nor welcome. This is an area of regulation that traditionally has been left to State legislatures and to the application of the business judgment rule by State and Federal courts. Further, legislation which discourages takeover attempts necessarily interjects Congress into decisionmaking regarding the proper allocation of credit and capital. These decisions are best left to the efficiencies of the financial markets.

By addressing individual tactics, Congress also risks unbalancing the present legislative framework to favor either bidders or targets. Any action which favors one group over another is at the very best an implicit judgment that tender offers are either good or bad—a judgment which we, like the authors of the Williams Act, should refrain from making. Moreover, congressional activity in such a rapidly evolving area of the law may be either premature, tardy, or totally unnecessary. Court decisions, shareholder actions, amendments to corporate charters and by-laws subject to shareholder approval, and stock exchange rules may provide adequate solutions to many of the concerns raised by those urging Congress to ban certain offensive and defensive tactics.

The testimony of the numerous witnesses was distinguished by the considerable expertise they provided to the subcommittee and by their failure to agree on an appropriate regulatory or legislative response to the various offensive and defensive tactics employed in takeover battles. Despite this general disagreement, a consensus did emerge that the imperative objective of any amendments to the Williams Act must be to increase shareholder protections. The protections to shareholders intended by the act have been eroded by recent developments and legal interpretations of the rules governing the takeover process. Shareholder protection can be enhanced by making what may be considered procedural, rather than substantive change to the Federal securities laws governing takeovers. Procedural changes to the regulation of takover activity are entirely consistent with the legal framework of the Federal securities laws.

The determination of an appropriate legislative response to the issues addressed at the hearings of the Securities Subcommittee has been greatly influenced by the legislative history of the Williams Act. In 1968, Congress enacted the Williams Act to provide a framework for the regulation of corporate takeovers in the national marketplace. The Williams Act was designed to fill a gap in the securities statutes to ensure that investors and target companies had adequate information and opportunity to make investment decisions in transactions designed to cause, or resist, a substantial shift of ownership away from the existing securities holders. The Williams Act was not intended to discourage or encourage takeover activity or to provide management or any other group with special privileges or advantages over another. The act was not designed to regulate the conduct of management or bidders or the tactics they employed to thwart or effectuate a takeover. The Williams Act sought to avoid tipping the scales either in favor of management or in favor of the bidder; to require full and fair disclosure to shareholders; to provide the bidder and management equal opportunity to participate in a tender offer. We should not stray too far from these principles unless Congress is willing to make normative judgments concerning the appropriateness of corporate decisions.

This legislation contains amendments to the Williams Act consistent with the original intent of that act's authors. The proposed legislation modifies the act to ensure that it continues to protect investors and the public interest without placing undue impediments that thwart honest and lawfully conducted takeover transactions. Legitimate corporate takeover activity will not suffer by the enactment of this legislation. The modification of the disclosure requirements of section 13 and 14 of the Exchange Act combined with the procedural modifications contained in the legislation will benefit investors and discourage pure financial plays.

Prudence dictated the development of a balanced legislative response unless we are determined to impede the tender offer process. Legitimate tender offers, as distinguished from greenmail or pure financial plays, have a disciplining effect on incumbent management. Tender offers also provide economic benefits to the shareholders of a target who wish to participate in the offer. However, it is a difficult task to draft legislation which discerns between offers that may be considered pure financial plays and restrict these without simultaneously impeding legitimate takeover activity. Moreover, restrictions on legitimate takeovers imposed by the Congress designed to reduce or eliminate takeover activity could deprive shareholders of potential opportunities to participate in an offer. The imposition of across-the-board restrictions on specific offensive and defensive tactics which would inhibit or promote such transactions involves Government interference in the free market's determination of credit and capital allocation.

Finally, it is not clear that substantive changes in the Federal securities laws governing tender offers would have any clear benefits for stockholders or for the economy in general. Contrary to claims that takeovers force corporate managers to sacrifice long-term investment planning for short-term profits, there has been no conclusive demonstration that tender offers are detrimental to the economy. Further, little conclusive evidence exists that demonstrates that tender offers have a disruptive effect on domestic credit and capital markets. There is evidence, however, which suggests that economic factors such as interest rates, inflation, the present structure of federal corporate taxation, and consumer demands influence corporate planning to a far greater extent than the fear of corporate raiders. Therefore, it is preferable to allow individual companies to decide whether and how they want to acquire other companies or to protect themselves than to have the Federal Government impose rigid restrictions which govern corporate conduct during takeover battles.

Ideally, the legislation described below satisfies the objectives that the subcommittee intended to accomplish when it began its inquiry. Some critics will attack it as unresponsive to the needs of the beleaguered incumbent managements threatened by the spectre of a hostile raider looming just beyond the horizon. Others will contend that the legislation represents an unwarranted Federal intrusion into the marketplace. They see no merit in any regulation that diminishes a shareholder's ability to reap the rewards to be gained from corporate raiders who claim that they are compelled to act out of concern for the shareholders best interest and to promote economic efficiencies, rather than a desire for personal profit.

To these critics I would respond that neither this legislation, nor the Williams Act is designed to protect the jobs of incumbent managements or to ensure the success of a hostile offer by removing every impediment management may place in a raider's path. This legislation is not intended to benefit either target managements of bidders. The intended beneficiaries of this legislation are the shareholders affected by contests for corporate control. Shareholder protections will be enhanced by this legislation because it creates a more orderly process through which substantial portions or entire corporations are bought and sold in the trading market.

This legislation is needed to ensure that shareholders will be able to make well informed investment decisions on the disposition of their holdings in a corporation subject to a takeover. The legislation is not intended to promote or impede takeover activity because, frankly, the Federal securities laws were not designed and should not be employed to affect the economic policy of this country. Such public policy decisions which limit corporate takeover activity may ultimately prove justified, however, such changes should not be implemented through the "backdoor" by amending the Federal securities laws. Thus I strongly urge prompt and favorable consideration of this legislation by my colleagues. I ask unanimous consent that the explanation and analysis of the bill and the bill be printed in the RECORD.

EXPLANATION AND ANALYSIS

Section 1 of the bill states that the bill may be cited as the "Tender Offer Reform Act of 1987."

Section 2(a) amends the reporting requirements of section 13(d) of the Securities Exchange Act of 1934—Exchange Act. Currently, under section 13(d) of the Exchange Act, any person who acquires more than 5 percent of a class of equity securities of an issuer must, within 10 days after acquiring more than 5 percent, notify the issuer and file with the Securities and Exchange Commission [SEC] a statement containing certain information about the acquiror's background, the source and amount of funds used to make the acquisition, any intentions to acquire control of the issuer, and other information prescribed by statute or Commission rules.

Section 13(d) in its present form permits the notification and filing to occur as many as 10 days after the 5 percent threshold is exceeded. The 10-day threshold has frequently failed to supply stockholders, the trading markets, and the public with timely information about the identity and intentions of the purchaser. The 10-day interim filing period between the purchase of more than 5 percent and the reporting of the acquisition has been used to the unfair advantage by acquirors who continue to buy large amounts of securities before notifying the issuer, the SEC and the trading markets. Recent acquisitions demonstrate that the 10-day filing period allows an acquiror to gain controlling interest in a company before the company and the trading markets were notified of the acquisitions.

Section 2(a) eliminates the 10-day interim filing period by requiring that a person, who acquires more than 5 percent of a class of equity securities, publicly announce that acquisition and file the materials presently required by the Exchange Act with the SEC, the issuer and to each exchange upon which the security is traded within 24 hours of the acquisition. The acquiror is then precluded from acquiring additional securities of the same class for 2 business days after the acquisition that caused the acquiror's obligation to file the report, or such shorter period as the SEC may prescribe.

Section 2(a)(2) specifies the information that must be contained in the public announcement required by section 2(a)(1).

Section 2(b) permits the SEC to exempt by rule, regulation or order certain acquirors from the terms and conditions of section 2(a) if the SEC determines that such an exemption is in the public interest.

Section 3(a) and 3(b) are technical and amend sections 13(d)(3) and 13(g)(3) of the Exchange Act. Sections 3(a) and 3(b) apply the provisions of sections 13(d)(3) and 13(g)(3) of the Exchange Act to groups acting in concert for the purpose of voting securities. Although the statute currently applies to groups acting in concert for certain purposes, this section clarifies the application of the statute to groups acting in concert for the purpose of voting securities.

Section 4 amends section 14 of the Exchange Act, section 14 of the Exchange Act is commonly referred to as the Willians Act. Sections 4(a)(1) and 4(a)(2) are technical in nature.

Section 4(a)(3) adds a new provision to the Williams Act. This section is designed to effectuate the original purpose of the Wiliams Act by requiring that the shareholders of a company subject to a takeover receive adequate information of the offer in a comprehensible form. Under section 14(d) of the Exchange Act, a person making a tender offer for, or a request or invitation for tenders of any class of any equity security registered pursuant to section 12 of the Exchange Act must file certain information with the Commission and publish information for shareholders of the securities sought by the acquiror.

An examination of the materials that shareholders received pursuant to a tender offer demonstrated that, while these tender offer materials provided adequate disclosure in accordance with the technical requirements of the Williams Act and SEC regulations, the materials were often of little use to shareholders. The information contained in the tender offer materials received by shareholders is not easily comprehended by the average investor or in some cases by sophisticated investors and market professionals. In the absence of any clear explanation of the offer, investors must reply on information about the offer as provided by the media.

Although such reliance may not be misplaced, the intent of the Williams Act was to ensure that shareholders received an explanation of the terms and conditions of an offer from the offeror. Although shareholders are literally bombarded with information about the offer, well informed investment decisions are difficult where these tender offer materials prove incomprehensible.

Section 4(a)(3) resolves the shareholders' dilemma by requiring that an executive summary of the material terms and conditions of a tender offer be provided in addition to or included in the other tender offer materials received by shareholders. The information to be provided in this summary is described in the subsections of section 4(a)(3). The acquiror must publicly announce any change of the information contained in these subsections. These provisions require that shareholders receive a brief explanation of the information similar to the information presently provided to the Commission pursuant to the requirement of schedule 14D.

Subsection 4(a)(3)(ii) is specifically designed to address the issue of valuing the price of two-tier tender offers. The subcommittee has received testimony citing the potential confusion and the pressures experienced by shareholders and confronted by a two-tier offer. This subsection is intended to require the bidder to provide information concerning its valuation of the second step of a two-tier offer and an explanation or accounting of the determination of the value ascribed to the second step payment where that payment is not an all cash offer.

Subsection 4(a)(3)(vi) is designed to address issues related to an acquiror's intentions to liquidate or merge the issuer or make any other change in its business or corporate structure. The acquiror would also be required to disclose its intentions to relocate material portions of the issuer's business activities, including its principal executive office and other major restructurings that would affect the issuer's management or employees. This provision does not require a statement of the effects of a change in corporate control upon the relevant community or communities. Therefore, it should be viewed as a corporate impact statement rather than as a community statement.

Subsection 4(a)(3) is not designed to create a new legal cause of action in addition to those that presently exist under the disclosure provisions of the Exchange Act. It is designed to ensure that shareholders receive more adequate and useful disclosure of the terms and conditions of a tender offer and its effects on the target corporation.

Section 4(a)(4) amends section 14(d) by adding a new paragraph that extends the minimum offering period for tender offers. The minimum offering periods required by section 4(a)(4) distinguish between tender offers for any and all outstanding shares of a company's stock and two-tier tender offers and an offer for less than all of the outstanding shares of a company's stock, partial offers. The minimum offering period for tender offers for any and all of a company's outstanding share will be 30 calendar days. The minimum offering period for two tier tender offers and partial offers will be 40 calendar days. Under current SEC regulations, the minimum offering period for all tender offers is 20 business days. Section 4(a)(4) shall not apply to an issuer tender offer, if it is not made in anticipation of or in response to another person's offer.

The extension of the minimum offering period is designed to benefit shareholders by providing them more time to consider and to assimilate information regarding a takeover attempt. The extension of the minimum offering period will also provide the SEC a greater opportunity to examine a tender offer prior to the termination of an offer and to determine whether the offer was made in compliance with the Williams Act. Hopefully, the extension of the minimum offering period will discourage the use of abusive defensive tactics by a target's management who often feel compelled to employ these tactics in an effort to buy time. The extension of the minimum offering period provides a target's management with a greater opportunity to solicit higher alternative bids. These higher bids and the higher premiums provide another benefit to shareholders.

The distinction between the 30-day minimum offering period provided for any and all offers and the 40-day minimum offering provided for two-tier and partial offers is justified due to the more complex nature of latter two types of bids. Given the terms and conditions of an any/all offer, 30 calendar days should provide shareholders sufficient time to receive and consider tender offer materials and to make an informed investment decision. Given the notice to the market and target shareholders by the initial any and all bid, shareholders should have sufficient time to receive and consider these materials and to make an informed investment decision if the minimum offering period for a subsequent competing bid is 20 calendar days. The minimum offering period in section 4(a)(4) also contains a provision that prevents the termination of a subsequent competing bid prior to the expiration of the initial offer.

By comparison, the terms and conditions of two-tier and partial offers present shareholders with more complex investment decisions. Current regulations under the Williams Act make little regulatory distinction between full, partial and two-tier offers. Witnesses appearing before the committee argued that the use of two-tier and partial offers should be restricted or banned.

Opponents of two-tier and partial offers argued that these offers coerced shareholders into making investment decisions against their will. Others argued that partial offers provided positive economic effects and that two-tier offers provided shareholders of a target company higher premiums than offers with no second steps. Moreover, empirical evidence provided to the subcommittee demonstrated that the blended value of the premiums received in a two-tier offer were higher than premiums paid for cash offers. However, the reasons advanced by those advocating the equal treatment of any and all, partial and two-tier offers did not outweigh concerns with respect to the potentially coercive elements of partial and two-tier bids.

Rather than prohibit the use of partial and two-tier offers, prohibitions inconsistent with the underlying legal philosophy of the Williams Act, the minimum offering period is extended to 40 calendar days. This extension should eliminate the more coercive elements of these offers by providing shareholders more time to evaluate the value of partial and two-tier offers and the consequences that participation in or a failure to participate in such offers would have on the value of their holdings. The distinction in the minimum offering periods between any all and partial and two-tier offers operates as a regulatory disincentive against use of partial and two-tier offers in contests for corporate control.

When a subsequent bid is made pursuant to an initial partical or two-tier offer, section 4(a)(4) requires that the subsequent offer remain open for a minimum of 30 calendar days. Given the notice to the market and target shareholders by the initial bid, shareholders should have sufficient time to make an informed investment decision if the minimum offering period for a subsequent competing bid is 30 calendar days. The subsequent bid will not be allowed to terminate prior to the expiration date of the initial bid.

Section 4(a)(7) adds a new subsection (f) to section 14(d) of the Exchange Act to prohibit the award of golden parachute agreements. Present subsections (f) and (g) have been redesignated as subsections (l) and (m) respectively. This provision prohibits an issuer, during a tender offer, from entering for amending agreements that increase directly or indirectly, the current or future compensation of any officer or director. The practice of awarding golden parachutes during the pendency of a tender offer presents the appearance of self-dealing by the management of a target company at the expense of its shareholders. The prohibition extends to provisions "whether or not independent on any event or contingency." Thus, the prohibition affects termination agreements, large salary increases or stock options if they are precipitated by a tender offer.

This section neither prevents the hiring of new officers or directors, nor increases in compensation, if such actions resulted from an agreement predating a tender offer. The prohibition does not apply to routine compensation agreements undertaken in the normal course of business. Golden parachute agreements adopted in the normal course of business that are disclosed to shareholders are not prohibited. Such agreements do not exemplify the type of abusive self-dealing the legislation would curb. Although recent amendments to the Tax Code discourage golden parachute payments by increasing the tax imposed upon them, additional legislation is required to prohibit golden parachute agreements adopted during a contest for corporate control.

Section 4(a)(7)(g) adds a new section (g) to section 14 of the Exchange Act. This section limits a corporation's ability to make greenmail payments. Greenmail constitutes a repurchase, at a significant premium, of a block of an issuer's stock held by a person threatening a takeover. The payment of greenmail is unfair to a company's shareholders because it unjustly rewards the recipient of the greenmail payment at the expense of the remaining shareholders. Such payments are in effect discriminatory offers that exclude a substantial majority of a company's shareholders. This section prohibits a company from purchasing its securities at a price above the average market price of the securities during the 30 perceding trading days from any person who has held more than 5 percent of its outstanding shares for less than 6 months. The payment of greenmail to a person covered by this section would be permitted upon the approval of a majority of the shareholders or the company's making an equal offer to its other shareholders.

Section 4(a)(7)(h) provides a new subsection (h) to section 14 of the Exchange Act. This subsection authorizes the Commission to grant exemptions from new sections 14(f) and 14(g) of the Exchange Act. This section enables the SEC to use its exemptive authority to: First, prevent unintended or inequitable results; second, avoid the application of these sections to transactions which do not present the abuses or consequences that this legislation is designed to address; and third, provide for flexible administration in a rapidly evolving area of the law, consistent with the SEC's investor protection mandate.

Section 4(a)(7)(l) adds a new section 14(l) to the Williams Act that addresses the issues raised by large open market purchases that affect corporate control. The takeover contests between the Limited and Carter Hawley Hale Stores and Hanson Trust PLC and SCM Corp. are examples of large purchases that were determined not to constitute conventional or unconventional takeovers. In both cases, large percentages of a target's share and the corresponding ownership interests were transferred in transactions that were not considered as conventional or unconventional tender offers and were therefore considered to be outside of the coverage of the Williams Act.

The SEC challenged the legality of the purchase program of Carter Hawley Hale and argued that the company's purchases constituted an unconventional tender offer. In SEC versus Carter Hawley Hale Stores Inc., the court allowed the purchase of a large percentage of a target company's shares in a short time without requiring compliance with the Williams Act even where the purchase program was undertaken to defeat an offer conducted in accordance with that statute. The decision in Hanson Trust PLC versus SCM Corp. suggests that a bidder can begin a tender offer, thereby calling into play market forces that facilitate large accumulations of a target's stock, and then terminate the offer to take advantage of the market forces to purchase quickly an amount of stock in the open market that affects corporate control. This decision also suggests that an equal opportunity for shareholders to participate in tender offer transactions is not a goal of the Williams Act and that sophisticated investors do not need the protections of the act. The decision demonstrates a fundamental failure of the court to comprehend the purpose of the investor protections provided by the Williams Act. This section should clarify any judicial misconstructions of the Williams Act. The act is designed to treat all shareholders equally regardless of their level of sophistication and to ensure that all shareholders accorded the opportunity to participate in an offer at the same terms and for the same price.

Open market purchases that constitute unconventional tender offers merit regulation because a purchaser can effectively acquire control of a corporation without paying the premium that usually accompanies such acquisitions. The shareholders are thereby denied the opportunity to realize a control premium. Further, some shareholders are either entirely excluded from participating in the purchase or prevented from having their shares taken up on a pro rata basis as would be the case in a tender offer conducted in compliance with the Williams Act.

Section 4(a)(7)(l) limits the inequities suffered by shareholders in open market purchase programs that result in changes in corporate control by placing limitations on an acquiror's ability to acquire control by huge open market purchases that are not subject to the Williams Act. This section prohibits the acquisition of more than 2 percent in open market purchases of a company's outstanding securities in the calendar year after a person acquires beneficial ownership of 20 percent of a company's outstanding shares. The acquiror can continue to acquire 2 percent through open market purchases in each subsequent calendar year. Any acquisition above the 2-percent level in a calendar year once the 20-percent threshold has been reached can only be accomplished through a tender offer.

The 2-percent acquisition level is designed to permit acquisitions that are not substantial. Therefore, the requirements of this subsection do not apply to any acquisition or proposed acquisition when combined with all other acquisitions effected during the preceding 12 calendar months does not exceed 2 percent of the outstanding shares.

This section also contains exemptions that apply to: First, acquisitions by gift, inheritance, bequest or other involuntary; second, acquisitions by a statutory merger or combination consummated under the laws of the issuer's state of incorporation; or third, any acquisition that the SEC by rule or regulation exempts in the public interest and consistent with the protection of investors. The exemptive language in this section and the other sections of the legislation grant the SEC the authority to exempt any transaction if the particular transaction will not change or influence control of the issuer or otherwise is not comprehended with the purposes of the Williams Act or the amendments to that act contained in this legislation.

Section (4)(b)(k)(1) amends section 14 of the Exchange Act by defining persons for purposes of subsections (d), (e), (f), (g), and (i) of section 4(a) to include a group of persons, utilizing language similar to current section 14(d)(2). The statute thus makes explicit that the definition, which the Commission has interpreted as applying to current section 14(e), governs all tender offer provisions.

Section 4(b)(k)(2) provides that in determining for purposes of subsections (d), (g), and (j) of section 4(a), what constitutes a specified percentage of a class of any security, of the class shall be determined to consist of the outstanding securities of the class, exclusive of securities held for the issuer or any subsidiary of the issuer.

Section 5 states that none of the provisions of the legislation limit the SEC's authority to supplement proration, withdrawal or minimum offering periods. The SEC has, and has exercised this authority under existing law.

The effective date of the legislation will be the date of enactment. The legislation does not apply to any tender offer that commences prior to the date of enactment.

Section 6 is intended to address the issues generated by the increased usage of high yield, noninvestment grade bonds as a corporate finance technique. A great deal of publicity about the use of high yield, noninvestment grade bonds has been generated by the use of these bonds to finance hostile corporate takeovers. Critics of the issuance of these bonds contend that they may not be suitable investments for the depository institutions, pension funds and other financial institutions that invest their assets through the purchase of these bonds. Supporters of high yield, non-investment grade bonds counter such criticisms by contending that: First, the overwhelming majority of these bonds are used to finance corporate activity other than hostile takeovers; second, these bonds have a significantly lower default rate than commercial bonds and other direct investments of the affected depository institutions; and third, relatively few depository institutions are permitted to purchase these bonds and that these bonds have not eroded the safety and soundness of these institutions.

At present, several legislative proposals have been introduced that would curb investment in high yield, noninvestment grade securities. Legislation that requires the imposition of these restrictions may ultimately prove necessary. However, attempts to develop an adequate legislative solution to curb investment in these bonds proved difficult due to a lack of information regarding the performance of investments in these bonds. Before restrictions are imposed that affect the issuance of and the investment in these bonds, further information is required to help us determine the nature of such restrictions or limitations.

The suitability of investments in high yield, investment grade securities addressed is a topic that should be addressed in the Banking Committee's continued deliberations on tender offer reform.

The ability of Federal regulators to limit or restrict investment by federally insured depository institutions in such bonds should also be reviewed. These Federal agencies are empowered to restrict or prohibit any unsafe or unsound practices that would contribute to a weakness in an insured institution's financial condition. Prudence dictates that, before such investments are limited or prohibited and issuers suffer the unintended consequences of such restrictions, the breadth and depth of the market in high yield, noninvestment grade bonds be determined. Further, before legislation is enacted, Congress should consider expanding the scope of the supervision and enforcement powers of the regulatory agencies. Such an expansion of powers provides a more flexible approach to the regulation of investments in these securities. The information required in the study mandated by section 6 should provide Congress with timely and adequate data upon which to base its legislative deliberations.

Section 6 requires the Comptroller General, in coordination and consultation with the Securities and Exchange Commission, the Federal Home Loan Bank Board, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Savings and Loan Insurance Corporation, the Federal Deposit Insurance Corporation, the Secretary of the Treasury and the Secretary of Labor to study the issuance and investment in high yield, noninvestment grade bonds for the 5 years prior to the enactment of this act, including:

First, the identity and rating—as determined by Moody's, Standard and Poor's or other nationally recognized bond rating house—of the issuers of these bonds;

Second, the identity of the major purchasers of these bonds including, but not limited, to federally insured depository institutions;

Third, the percentage of the total amount of high yield, noninvestment grade bonds that are issued as a method of financing corporate takeovers;

Fourth, the identity of the purchasers including, but not limited to, federally insured depository institutions, that invest in high yield, noninvestment grade bonds that are issued as a method of financing corporate takeovers;

Fifth, the purposes of which high yield, noninvestment grade bonds are issued other than for financing corporate takeovers;

Sixth, a summary and analysis of the adequacy of current State and Federal laws that regulate investment in high yield, noninvestment grade bonds, by investors including, but not limited to, federally insured depository institutions and pension funds and;

Seventh, a review of the impact of the issuance of and investment in high yield, noninvestment grade bonds upon corporate debt as it relates to Federal monetary policy.

The study will be submitted to Congress within 120 days after the date of enactment of this legislation.

Mr. CHAIRMAN. Thank you, Senator D'Amato. Senator Sanford also has a statement for the record.

STATEMENT BY SENATOR TERRY SANFORD

Senate SANFORD. Today's testimony has offered an important reminder that takeovers affect not only shareholders and profits, but workers and pensions, as well. This truth is painfully apparent in the case of the Schick Company's takeover of the Reeves Brothers textile plants in the Carolinas.

For years, workers at the Reeves Brothers plants have had part of their wages deferred into a pension fund. While retirement benefits are low—averaging $61 a month for retired hourly workers—the pension fund balance has grown to over $20 million. Ordinarily, the purpose of such pension funds is clear: by law, they can be used only for the benefit of employees, and not for general corporate purposes. In recognition of this fact, employers' contributions to pension funds are tax-free.

Unfortunately for the workers at Reeves Brothers, their retirement funds were not as secure as they believed. Through a loophole in the law, pension funds can be dissolved and sold off as part of a corporate takeover. In this case, the workers' pension fund is serving as a piggy bank to finance the buyout of the company. In this transaction, only the shareholders stand to win. The workers, who have no protection, lose big.

Unfortunately, this situation is not unique. Corporate raiders have seized upon pension funds in a number of hostile takeovers. Since 1980, nearly $12 billion has been diverted from retirement funds to corporate coffers. What makes the Schick-Reeves deal unique is the covenent in the loan agreement that requires the company to liquidate the pension fund to finance the buyout. This sets a dangerous precedent.

The Senate Labor Subcommittee is looking into ways to reform pension laws to protect workers. I have written to Senators Metzenbaum and Quayle, urging them to involve provisions to protect workers in corporate takeovers. We must put an end to this unconscionable raiding of workers' pension funds.

I would like to thank Mr. Sheinkman for his testimony today and for all his efforts on behalf of the Reeves Brothers employees. I look foward to working with him to remedy this situation.

Mr. CHAIRMAN. Mr. Donahue, I think when you say in your statement that in the aggregate, no economic benefit is produced by hostile takeovers," you are, in my judgment right. But the key word is "in the aggregate."

HOSTILE TAKEOVERS CAN BE BENEFICIAL

I take it that you don't deny that there are some hostile takeovers that can be constructive. Is that right?

Mr. DONAHUE. I think, Senator, that we certainly would not suggest that we turn the entire financial world on its ear and prohibit purchases, takeovers, acquisitions, by any manner or means.

I am not a management expert. I am not capable of judging whether some hostile takeovers are good or not. I have to assume some are.

But what we would argue for is arranging the conditions under which those takeovers take place so that some careful thought can be given to them, so that the stockholders of both the acquirer and the target can be consulted, slow down the process, prohibit the abuses that are in it. And I think maybe then the answer to your question may well be, yes, there are some hostile takeovers which would be of some benefit.

Mr. CHAIRMAN. That's very helpful because the argument is that there are some managements that are incompetent. One way to get rid of them, of course, is through competition and through the stockholders recognizing that their management isn't doing well and replacing it. Another is through people feeling that they can take over those resources and assets, manage them better and more efficiently, and this, of course, may be productive.

But I think your case is very well made and from everything I've seen, in aggregate, overall, the net effect of these hostile takeovers has been adverse.

Mr. Donahue, you stress that takeover mania often results in companies loading up with huge sums of debt either to finance the takeover or to defend against it. But to sustain that debt, they are forced to lay off countless workers and close factories and retrench research investment.

LAYOFFS MAY BE DUE TO REDUNDANCY

Yet some economists and raiders will argue that layoffs are due to redundancy following a merger. That is, it's more efficient to operate one factory at 100 percent capacity than two factories at 50 percent capacity. Closing one factory is natural as is laying off redundant workers.

How do you respond to that argument of economic efficiency?

Mr. DONAHUE. If I'm only asked to respond to it in the same theoretical framework in which it's offered, Senator, I have no problem. I'm sure one factory operating at 100 percent capacity is more efficient than two at 50 percent.

That's not the real world, though. The real world that you're trying to address I think is a world in which the people who are motivated in these takeovers are not dealing with increasing capacity or increasing the efficiency of the operation that they're looking at.

For the most part, they are playing out a Business Week's Monopoly game and they are not looking, for the first time I think in American history—they are not looking at acquiring companies so that they might operate them more efficiently. They are looking at companies so that they can sell off the pieces, so they can reduce work forces, so they can disavow contractual commitments, so they can reduce wages, so they can displace workers.

I'm not sure that that adds anything to the efficiency of the corporation and certainly it doesn't add anything to the social situation of the Nation.

The CHAIRMAN. You would agree, however, I take it from the first part of your answer, you would agree that it may be in the interest of efficiency to lay off workers under some circumstances?

Mr. DONAHUE. In the theoretical sense, yes.

The CHAIRMAN. I know you're in a difficult position. On the other hand, the time comes when, cruel as it may be and catastrophic for the individual involved, you have too many people working for a particular company and you have to make some layoffs.

Mr. DONAHUE. Sure, Senator. I think the record of the American trade union movement is pretty clear on this. We recognize and have lived with the economic realities of our industries for all the years of our existence.

I don't think any one of us is proud of a record of taking wage cuts or the concession kind of bargaining that we've had to engage in in a number of instances in the past years, but it's been done and our unions have been realistic about what's possible in this kind of an economy.

I think the record of our unions in terms of looking to the health of the business is a quite good one. I suspect somebody can point out excesses here or there, but in the overall it's quite a good record. And the reason for it is simple. Workers are concerned about saving the business and therefore saving their jobs and maintaining those jobs.

The CHAIRMAN. Let me ask you, to what extent are union officials generally invited to discuss mergers, both friendly and unfriendly? Do you think union officials can play a productive role?

Mr. DONAHUE. I don't know of any that have been invited into the discussion of a prospective merger, Senator. I think that what I tried to point out in the statement, is the folly of the current situation in which these pieces are shifted back and forth and then when the shifts are over then there's an appeal to the workers whose morale has been totally destroyed, who are now frightened to death about their prospects of future employment and what the conditions of that employment are going to be, they are now told, of course, we all have to work together. Now you're presented with the fait accomplis. Now we have to all work together and we have to cooperate to increase our competitiveness.

Well, that's nonsense. I think the way to get that cooperation is to make trade unions—their members and their officers—partners in an operation. If a merger is seriously considered or an acquisition is seriously considered and if there is time for thoughtful contemplation of that by the stockholders of both companies, then there will be time for discussions with the unions involved and involvement of the workers in both companies.

The CHAIRMAN. I've talked recently to a group of top corporate executives and they recognize that they need you. They need the support of the union. They need the support of their employees in this battle if they are going to make any real progress politically with this committee or with the Senate or with the House.

So I think you are going to play a more active role in the future at their invitation.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Donahue, Senator D'Amato at some length detailed his bill, S. 227. What do you think of it? Is is a pretty good bill?

Mr. DONAHUE. I think it attempts to address—I must say, with apologies to Senator D'Amato, I haven't read or studied S. 227. As he outlines it and as I've been informed of it, it would go a long way to address some of the problems in the current tender offer system and reform that system.

It would not meet all of the issues which we tried to raise in our testimony and I am pleased to see the inclusion in that bill of the community impact statement because we think that's terribly important for the community to be informed and have a chance to review the situation, and in the community I obviously would include the employees and their representatives. I think that's terribly important.

Lowering the threshold for filings is important. The golden parachute limitations obviously are important. We would like the bill or any bill reported by this committee to go further than that.

We would like to address the questions of the continuing vitality of contracts of both the acquired and acquirer and to address the problems of employment conditions, and we would like to see that included in that kind of legislation. The golden parachute issue, I'm not sure how that's addressed, but if that were to be addressed in an ERISA framework, then that may be something which has to be dealt with outside of this committee but could be referred obviously by this committee to wherever the authority is on an ERISA amendment to prohibit the kind of golden parachute arrangements.

UNDERFUNDED PENSION PLANS

Senator HEINZ. One topic I didn't hear you bring up—I may have missed it—is the problem of what can happen to underfunded pension plans in the event of a merger.

The Ohio and Pennsylvania, LTV steel is the result of a merger between J&L and Republic. In the process of acquiring Republic, the surviving company, LTV, took on a large amount of debt. Consequently and subsequently, that company has gone into chapter XI. A number of the company's promises to its employees, including its promise of health benefits for early retirees and the supplemental pension benefits of about $400 a month for early retirees until they reach age 62—those promises have basically been forgotten. They have been broken.

And were it not for some legislation Senator Metzenbaum and I passed, those benefits—at least health benefits—would not now be paid.

What about requiring either the full funding of a pension plan prior to any merger or at least the securing of sufficient assets sufficient to fund or secure the unfunded liability of a pension plan as a precondition for any mergers or takovers?

Mr. DONAHUE. I suppose it would have some merit, Senator, if it would improve the situation over what it is currently. But it seems to me the real answer to that problem is to improve the whole system of funding pensions, whether the companies are in the business of acquiring or being acquired.

I think the question of underfunded pension plans is one we probably ought to address in the ERISA legislation. The record is now clear there that the Pension Benefit Guaranty Corp. [PBGC] has just been loaded with underfunded pension plans and the disavowal of future benefits by those funds.

I would like to see the consideration of that issue be a consideration of the total issue of pension schemes in the United States.

If this would be a stop-gap way of getting there, then I would certainly favor it. If this would be a way of addressing that problem even in its narrow context——

Senator HEINZ. I wouldn't propose what I've mentioned as a substitute for doing what we have to do about the PBGC, although tackling that could be a very lengthy process, and I don't know when we're going to get around to it—sooner as opposed to later, I hope.

But I think you are going to see legislation from this committee—S. 227 or something like it—and I would rather have a partial answer right now than none for another 2 years. My time has expired.

Mr. DONAHUE. And I'm sure, Senator, we would be supportive of—we have a long record of recognizing when only half a loaf is available and would certainly be supportive of any steps that would improve the situation.

Senator HEINZ. Thank you.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Shelby.

Senator SHELBY. Mr. Donahue, some argue that takeovers have actually resulted in more efficient management which will allow our domestic companies to become more competitive here and also in the international market. That has been an argument and I would like you to speak to that.

Mr. DONAHUE. Again, Senator, I am not a management expert or an economist, but I would certainly have to say, sure, I'm certain that some of the takeovers are good and have improved management of corporations within however you define improved. If improved means improved their short-term earnings, then I guess that's happened.

Senator SHELBY. Well, I was thinking more of long-term productivity, long-term staying power in the marketplace.

Mr. DONAHUE. I think that's harder to prove and the studies that we've looked at seem to indicate that, on the average and in the mass of these things, the hostile takeover at least has not been beneficial either to the acquirer or to the acquired corporation, and that the net result has been a reduction even of stock values of those corporations 1 year and 2 years out.

Senator SHELBY. Of course, historically, as far as economics is concerned, we have always had some takeovers in this country.

Mr. DONAHUE. Sure.

Senator SHELBY. And in Europe and everywhere else. But is one of your problems been the acceleration of it and the displacement of workers and, as you would probably—I think you use the term "social good"?

Mr. DONAHUE. I don't think, Senator, that the takeover, as defined in the classic economics text or in the business schools of 20 years ago, is the problem.

The takeover of one company by another through a rational tender offer for the sake of improving the business of the two has——

Senator SHELBY. That's normal and everyday business.

Mr. DONAHUE [continuing]. Has gone on for lots of years. The problem is the totally new circumstances in which the Nation finds itself over the last 10 years probably in which you have the growth of the hostile takeover carried out by a group of adventurers who seek nothing more than the short-term run profit at whatever the social cost to the company, the employees, and the community.

Senator SHELBY. In the economic history of modern times in America, have you seen up until now the devastation anywhere other than where all these mergers and acquisitions have taken place? That is the closing of towns, like Senator Heinz mentioned Bartlesville, OK, earlier. Cumberland, MD, is certainly an example of that and I'm sure you could go on and on. We have never had that before, have we, to that extent?

Mr. DONAHUE. Not from these causes.

Senator SHELBY. That's what I'm talking about.

Mr. DONAHUE. And I think that is really the sense of why this committee is considering all this because we are confronted as a nation with a totally new set of facts and a totally unanticipated set of conditions.

Senator SHELBY. And different players in the marketplace?

Mr. DONAHUE. Exactly.

Senator SHELBY. What would your single most important reform action be legislatively deemed necessary to protect the employees' rights in a takeover situation?

PRESERVATION OF CONTRACTUAL RIGHTS OF WORKERS

Mr. DONAHUE. Clearly, in the narrow sense of protecting employee rights in a takeover situation, the question will have to be the sanctity of our contracts and the preservation of the contractual rights of the workers.

Senator SHELBY. And that would include pension rights?

Mr. DONAHUE. Yes, sir.

Senator SHELBY. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Shelby.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Donahue, United Airlines may be purchased by its employees. I take it you would favor such an acquisition. I say from this Senator's position it always seems to me that an employee purchase often benefits the corporation. You would be in favor of that, wouldn't you?

Mr. DONAHUE. I rarely disagree with our affiliates, Senator. [Laughter.]

PROPOSED ACQUISITION OF AIRLINE BY EMPLOYEES

I think that the proposed United acquisition is a fascinating one, though, as a commentary on the situation. A group of workers are driven to the most desperate means they can find to buy the company themselves so that they can preserve their employment and preserve an airline as an airline. And that's obviously the motivation of the United pilots in entering into that offer or I guess at this point it is only a discussion of their interests.

But there are arguments all around us about employee ownership and stock participation and all that, and there are all sides of those issues. But I think the United thing represents the ultimate extension of a group of absolutely frustrated workers who don't know anything else to do and see no other choice for them than to buy the damned company as a way out of the dilemmas that are caused for them by people who choose to use the company for totally different purposes than serving the Nation with an effective airline, treating employees differently, having a productive business enterprise.

Senator D'AMATO. Well, in order to preserve United as an airline and to continue its service to customers and employees who have given years of service to help build the company, they may have to turn to debt financing.

My point is that whether the acquisition is made by the employees or another bidder, they are going to have to finance the debt with loans or junk bonds or high yield bonds. And that's why I wanted to give you an opportunity to respond in this manner.

Would you preclude them from this takeover because junk bond financed deals are in your mind and the minds of other witnesses per se evil and therefore should be restricted or prohibited?

Mr. DONAHUE. I wouldn't prohibit them from playing in the market by the same rules that all of the other raiders are playing in these days, and if raiders can come along and use all of these techniques to destroy the employment or destroy the company, I find it hard to say that the pilots shouldn't be allowed to protect the company.

Do I think that the Airline Pilots or any other union should carry out tender offers in the future under a different set of rules? Yes, I absolutely do. For the current, obviously, they are going to play under the rules as they exist now and hopefully try to improve their position. They have not, incidentally, Senator—I'm not sure that the ALPA pilots in the United situation have described a resort to junk bonds or whatever. They have said that they would use a substantial portion of their own pension funds to try to buy the company and I think that attests to the desperation. They are willing to take their whole pension or a large part of their pension program and bid it on United Airlines.

Senator D'AMATO. My point, Mr. Donahue, is really that I don't believe we should attempt to distinguish between a good or bad takeover by the identity of the bidder. And more importantly, I think we really do ourselves a disservice by identifying high yield bonds or junk bonds as the culprit in the legitimate problems of concern that you have outlined in your statement as it relates to takeovers.

I think you have addressed many and I commend you for having focused attention with respect to some abusive activities, whether they be the sweeping of the street, whether they be the golden parachute or greenmail practices. I would hope that we would have an opportunity maybe at a future date or maybe even privately to discuss specific reforms.

As for the issuance of junk bonds, I do not believe we should simply preclude them. I don't think they are the problem. I think that there are other underlying problems, but they have been the easy target that many have made and they have tried to blame them and I don't think they are the evil that some have portrayed.

Mr. **Donahue.** If I may, Senator, I don't believe our testimony includes a condemnation of the entire concept of junk bonds but, rather, the question of the use of those bonds and the amount of those bonds involved in leveraging an acquisition. I think there are legitimate purposes for junk bonds and a lot of companies in trouble have been able to salvage themselves through their use.

Senator **D'Amato.** I wonder if we could have another opportunity to discuss this. I won't be able to do it today because of the press of hearings, but I would like to follow through, Mr. Chairman, with Mr. Donahue as it relates to this issue. I think it's important that we have some clarity in regard to the terminology where junk bonds have become synonymous with the big evil. I think there are other takeover techniques that pure financial speculators employ which have cast a bad light on junk bonds, but I don't think it's the bond itself that poses the real problem.

The **Chairman.** Senator Graham.

Senator **Graham.** Thank you, Mr. Chairman.

I would like to follow up on the line of questioning that Senator D'Amato was pursuing relative to employee takeovers.

Are there any special considerations that you would feel this committee should take into account where the potential acquirer is the employee organization or individuals?

Mr. **Donahue.** I must say, Senator, I haven't thought that question through in terms of any special exemptions that I would offer.

I think the process of slowing down the acquisitions that we argue for, the question of stockholders' right to vote—stockholders of both the offerer and the target—is a sound one because it will give people time to think about the process.

I think wherever there is an employee group engaged in a takeover, they would welcome that kind of thoughtful consideration of their offer. So I don't see any conflict with that. I don't mean to argue against employee takeovers where they are demonstrably either beneficial to the workers involved or are a last ditch effort to try to save jobs. But neither do I think that they are the salvation of the American economy or are going to become anything but the exceptions to the rule.

Senator **Graham.** Let me ask another collateral question and possibly you would be willing to supplement your remarks on this issue.

EMPLOYEE-STOCKHOLDERS

We have companies—Eastern Airlines being one example and there will be some testimony on that later—where employees had, because of their willingness to engage in various efforts to preserve the economic integrity of the airline, had become significant stockholders and then there was an acquisition by a third party.

Do you believe that there are any special considerations that should be given to employee-stockholders of the existing company when that company becomes the target of an acquisition? Are there any considerations that are unique to a stockholder who happens to also be an employee or a representative of the employee that did not apply to stockholders generally?

Mr. DONAHUE. That's an interesting question, Senator. I think that's a subject that probably ought to be examined and I would like to explore it further with you.

Why shouldn't employee-stockholders have some special rights or some special type of stock share? Why shouldn't there be a special class of stock created which would give them some right superior to the person who is only a cash investor in the company? I think that's an idea that ought to be examined.

I think the problems we see are that there is a friction created that employees can own companies and they can share in the wealth of the company, share in the profits, and wonderful days are ahead and we will all go to the seashore together. And the fact is, we have never been invited in on a good one.

We are always invited in on the losers. Nobody with a highly prosperous company that I know of is proposing profit distribution schemes or stock distribution schemes to employees. Every time a company is in trouble, it's the first place that's looked to and we're always offered these wonderful buys on some company that is so deeply in trouble nobody else will put up any money for it, but now maybe the employees can save it and we can get for it a certain amount of stock in the company with the kind of play-out of circumstances that you see in Eastern in which the employee-owners are now faced not just with a hostile takeover but with an extremely hostile new management and all of the consequences attendant upon that.

I would like to review the question of, is there an ability to create some greater right in the employee-stockholder than in the cash investor in a company? I think it's a fascinating question.

Senator GRAHAM. Mr. Chairman, if I could just pursue one other area of questioning, it seems to me that the difficulty that this committee and Congress and society has with this issue is how do you separate the desire to have an open marketplace which maintains competitive tension and all the values that are supposed to flow from that as against from those activities which are essentially for acquisitional motivations alone where there's not an interest in building productivity on a long-term basis.

This, to me, is symptomatic of a deeper issue in our society and that is, how do we change the focus of economic decisions from tomorrow's stock price to what will be the circumstance of this business a decade from now. If you have any comments within this concept of corporate takeovers what we might do to create economic incentives that would look to the longer term and would help through the marketplace to distinguish those takeovers that are for long-term economic productive purposes as opposed to those that are just a quick buck scheme for the acquirers, I would be very interested.

Mr. DONAHUE. Corny as it may sound, Senator, I think that one of the ways to do that is for the American people to create a higher standard for corporate behavior than we have up to now.

Corporate managers—and I'm not talking about the investment community or the investment bankers who don't seem to be bound by the same rules—but corporate managers certainly are concerned about the opinion of the public and I think the public has demanded far too little of them.

We have never believed as a people that they had any responsibility beyond making money. I don't happen to believe that's true and I think a fair segment of the population doesn't believe that's true. But the fact is, we haven't created a national standard which says you not only have a responsibility to run your enterprise effectively and efficiently for whatever benefits that may produce in a capitalist system, but you also owe obligations to your workers and to the community and to the Nation as a whole, and we want to measure that contribution. I would love to see a section added to the annual filings in which every American corporation would be asked, "How many jobs did you provide for American workers in the last fiscal year and how many did you provide the year before that? I think that would be a fascinating measure of the effectiveness of the company and a measure of its contribution to the American economy.

We don't ask that. We think the company with the fewer employees and the higher dollar profit is the most effective company. I think that's wrong. So I think we have a lot to do in terms of changing the mind set of people as to what we demand of our corporations and I think some of our corporate managers—at least the serious managers of corporations would be enormously responsive to that changed public opinion.

Senator **GRAHAM**. Thank you.

The **CHAIRMAN**. Senator Riegle.

Senator **RIEGLE**. Thank you.

I think this discussion has been very illuminating. I think the issues that you're raising right now are part of the new debate in the country that must go on in light of the way the world economy has changed and the whole question of how we provide for ourselves as a Nation in the future. On the one side, the whole job base converts in terms of the work and the value added to what our national standard is. We are not going to have anything in the future to consume, whether it's publicly or privately, if we don't one way or another produce.

And this whole new set of questions, it seems to me, has come into a new form, into a new tradition, and this debate is really just beginning. But I think some of the issues that you've just raised in response to questions and in your very careful testimony—make a number of very helpful and constructive suggestions and as chairman of the Securities Subcommittee they are ones that I certainly will take account of as we draft a legislative proposal.

RAIDS ON PENSION FUNDS

Let me ask you two specific questions. One has come up before and that's the question of these raids on pension funds and you say in your statement, "to prevent the reorganization epidemic from infecting the pension system, acquirers should be precluded from using pension fund assets to finance an acquisition," and that seems very sound to me.

How attractive have these so-called overfunded plans become to corporate raiders insofar as you can judge, and to what extent is it true that these funds are actually helping to finance the takeovers of the companies with the plan?

Mr. **Donahue**. You are going to hear testimony I know, Senator, from Jack Sheinkman of the Amalgamated Clothing Workers about the Schick takeover of Reeves where 20 percent of the borrowed money was—the banks were assured that 20 percent of the borrowed money would be returned to them from the surplus assets of the pension fund, and that was a commitment made before the loans were granted. That's immoral. They said, "We're going to pay off these bank loans by taking the money from the workers' pension fund," and everybody signed on. The 10 participating banks said, "That's a hell of an idea. We ought to do that. We will all sign on and we'll get part of our money back right away." I think that's immoral.

I think you are going to hear much more eloquent testimony from Mr. Sheinkman on that point, Senator.

As to how widespread that is, I'm sorry, I just don't know the answer to that question.

Senator **Riegle**. Let me ask you this. Do you have any thoughts as to how that problem ought to be dealt with?

Mr. **Donahue**. Well, I think that we ought to say simply, one, that you can't use the assets of the acquired pension fund in the play, in the purchase of the company, not just the surplus assets but any of the assets of that fund. And that should be very carefully limited.

I think that the other suggestion which we make as to the responsibility of fiduciaries is also a critically important one, that fiduciaries now feel a legal responsibility to behave as everyone else does. Even the institutional investors, even the people who manage our pension funds feel that they have to behave like everybody else and they have to maximize their short-term profits in the market. And so they are all in there playing because they are afraid if they don't do it, then their returns are going to be lower and they will be criticized as inadequately performing their fiduciary responsibility.

I think there ought to be some different spell-out of those fiduciary responsibilities. Fiduciaries ought to be specifically told that it is perfectly correct for you to take into consideration questions other than the short-term profit to be gained in a particular investment, and if you choose to stay with a company which is fighting off a raid in which you can make a short-term profit by going with the acquirer, you won't be punished for that. That won't be deemed to be a dumb judgment by a fiduciary. I think it's important that that be said.

Senator **Riegle**. You also say that shareholders should be given a longer time period to respond to tender offers.

How far beyond the current 20 business day minimum would you like to see it extended?

Mr. **Donahue**. I think we've said 60 days, Senator, but it seems to me it takes more than 20 days to get mail out to people and for people to think through and read their mail and think through what's being proposed. We would like to see probably 60 days for that.

Senator RIEGLE. I just want to say in conclusion, that I think your suggestions with respect to making leveraged buyouts by incumbent management arm's length transactions—that's a problem that has not gotten a lot of attention because it tends not to get the sort of banner headline play that hostile takeovers tend to get. But I think that its something we need to take a look at.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman.

Mr. Donahue, it's good to see you again. I have had the opportunity to read your testimony. As in our previous discussions, there are a few areas I might ask for your further elucidation.

IMPACT OF TAKEOVERS ON COMMUNITIES

I noticed on page 10 of your testimony that institutional investors should take into account the impact of takeovers on communities.

Would you go so far as to have the AFL-CIO instruct that its members' pension funds not invest in the stock of a potential takeover target or give up profits that might be realized by the appreciation of assets in takeovers?

Mr. DONAHUE. Give up profits which it might appear can be realized in those acquisitions, yes. Senator, I think the answer is the comments which I offered Senator Riegle that we think institutional investors do represent a different kind of interest in the marketplace that the person who simply has cash and wants to buy stock. We think the trustees of those pension funds particularly should be able to examine more carefully the question of whether they go for the short-term profit and the acquisition or whether they look at the long-term benefit to a corporation by being left alone and providing stable employment in a community and having a high morale, well-producing work force. And I think the fiduciary should be assured that in making those kinds of judgments they are not going to be—they shall not be attacked for making those kinds of judgments.

So, yes, I would certainly think they should take that into consideration and I think the record is that much of the imagined profit in playing for these short-term gains is illusory and that a year down the road that stock has depreciated substantially.

Senator BOND. But you would have them vote against or refuse to take an offer at a substantial profit?

Mr. DONAHUE. I don't know how to answer that.

Senator BOND. Sell the stock at a time when there is an offer?

Mr. DONAHUE. I would ask them to take into consideration a whole range of effects of their decision. I would like to see a system in which the tender offer includes more than the dollar price for the stock but includes the statement of community impact, includes the statement about what the acquirer intends to do with this company, and where the financing is coming from and what its conditions are and so forth, as we said in the testimony.

With that kind of information, I think institutional investors could make mature business judgments, if they are freed of what they see as their current single responsibility to maximize short-term profits and it's a very complex judgment.

Senator BOND. So their interest in protecting the pensions and the retirement funds of their members should, in some instances, be secondary to some broader community responsibilities?

Mr. DONAHUE. Those interests should be secondary to maximizing short-term profits and they would have to make a fairly complex judgment.

Senator BOND. If it's a question of either you sell or you don't sell, you would say that decision should be made in the interest of broader community interests rather than the workers' interest in their pension funds?

Mr. DONAHUE. Senator, I'm afraid I can't answer it in the abstract. You have to tell me what pension fund we're talking about. If we're talking about the ALPA pension fund and a judgment that ALPA would make—its pension fund trustees would think about whether or not they should sell the stock in the XYZ airline which their pension fund holds, if they should sell that stock for a short-term gain to a raider who is going to destroy the company, I think they ought to be allowed to take that into consideration. I don't think they should be forced to say, "Well, my duty as fiduciary requires me to take the short-term profit even though the very members who this pension fund is set up to serve are going to be disserved by the acquisition which I'm promoting." I think they have to be allowed to take that into consideration.

Senator BOND. I was interested in the similarity of some of your suggestions to testimony that we had heard several weeks ago from corporate CEO's. We listened to several people who represented companies that had been targeted for takeovers and they proposed a variety of defenses, including community impact statements, essentially to protect entrenched management.

Do you think that workers are better off with protected management or would you rather negotiate with corporate management that didn't have all of these defenses to make sure it was not responsive to investors?

Mr. DONAHUE. I'm sorry, Senator. I just don't know how to answer it in the abstract. I don't know whether the management I'm dealing with is entrenched or shaky. That's a judgment people make in the specific circumstances. Would we rather protect the current management than a future management? That depends on what they were willing to tell us they wanted to do with the company.

If the current management is committed to a course of protecting the stability of employment and improving the conditions of workers, it would be foolish for us to say that management should be gotten rid of and we should bring in some risk-taker who is interested in short-term dollars and doesn't care about destroying our jobs. I think you have to look at each one as it comes along.

Senator BOND. Thank you, Mr. Donahue.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Senator Bond.

Thank you very, very much, Mr. Donahue, for superlative testimony and particularly for your very effective, intelligent responses to the questions. You have been an outstanding witness.

Mr. DONAHUE. Thank you, Senator.

Mr. CHAIRMAN. Our next witnesses are a panel consisting of William Wynn, president, United Food and Commercial Workers International Union; James Hatfield, president, Glass, Pottery, Plastics & Allied Workers International Union; Jacob Sheinkman, secretary-treasurer, Amalgamated Clothing and Textile Workers Union; and Milan Stone, president, United Rubber, Cork, Linoleum & Plastic Workers of America.

Gentlemen, we're delighted to have you here. Mr. Wynn, would you go ahead, sir?

STATEMENT OF WILLIAM H. WYNN, PRESIDENT, UNITED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION

Mr. WYNN. In fact, I will do that. I have a prepared text which we have submitted for the record.

My union represents workers in the food industry in this country. Three rather large food companies that are represented by my union have been confronted with this takeover problem, all of which, I might add, are very successful operators.

The food distribution system in this country is superior to any food distribution in any other foreign country. In fact, the three companies that were involved in these takeovers all were profitable and, by standards of outside experts, well-managed companies.

Safeway, where we have about 116,000 members in a company that had minimal debt and had great value and had an income of around $230 million a year, was confronted with the takeover situation where they had to secure a white knight to withstand the takeover. However, in moving in that direction, they had to create a debt of $4.2 billion or $4.6 billion.

Secretary-treasurer Donahue was asked by one of the Senators, "Are unions involved when a company is being taken over?" I can say to you as it relates to our companies, we attempted to involve ourselves. Further, we moved into court to try to get the court to order them to let us be involved in the takeover. That court decision, of course, has not come down yet and the company in question has already been taken over and the debt created.

We had seen the potential for loss of jobs. In the Safeway situation, as an example, to be able to pay off the indebtedness that was created by the takeover, Safeway will have to shut down 33,000 jobs throughout this country in various sectors. But the company's position to us was that that's not a fact and that there's no plan.

WORKERS OFFERED PAY CUT TO MAINTAIN THEIR JOBS

Now in a couple of situations, as an example, in the Eastern Shore of Maryland, I am sure that many of you read in the *Washington Post* that Safeway offered our workers an opportunity to take a $5.05 pay cut to pay for the takeover to be able to maintain their jobs.

In Dallas, TX, they will be closing down 6,000 jobs—not because the company wasn't profitable, not because the company was not an efficient operation, because it was an efficient operation, and not because our workers weren't productive, because they were. We have 6,000 workers who will be put out of work because they decided, and rightfully so, not to take the $6 an hour rollback.

So we agree with much of what secretary-treasurer Donahue said. As an organization, we are not opposed to mergers and acquisitions and we are not opposed to takeovers. There is no doubt that there have been some that have been worthwhile and some that have possibly made a company better.

In the three situations cited in my testimony, all three companies were well managed, and all three companies were highly profitable. In another company, Lucky's an operator on the west coast, 2 weeks before Christmas, 14,000 of our workers were laid off to be able to pay for the takeover threat that was placed against them.

We would like this committee and this body to bring some better sense to the process that exists now—a process that doesn't take into consideration workers' rights, and that allows corporations to make decisions based only on the increase in the stock value and not on the continued survival of the corporation or the best interest of the community or the workers.

With that, Senator, I will close. Thank you.

The CHAIRMAN. Thank you, Mr. Wynn.

[The complete prepared statement of William H. Wynn follows:]

UFCW

TESTIMONY OF WILLIAM H. WYNN, INTERNATIONAL PRESIDENT
UNITED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION
BEFORE THE U.S. SENATE COMMITTEE ON BANKING
APRIL 8, 1987

Mr. Chairman, members of the Committee: my name is William H. Wynn and I am International President of the United Food & Commercial Workers International Union. The UFCW encompasses 1.3 million working women and men in the U.S. and Canada, principally in the retail, food manufacturing and health care sectors. Some of them are with me today.

On behalf of all of our members, I want to thank the Committee for this opportunity to discuss our views of recent takeover fever in the United States.

In the last six months alone, tens of thousands of UFCW members and the communities in which they live and work, in every region of this country, have felt the full force of the current wave of stock manipulation. Thousands have lost their jobs; additional thousands have been threatened with the alternative of losing their jobs or working at poverty wages -- all to pay off a few investment bankers, bondholders, lawyers and corporate raiders. We believe that the inadequacies and abuses of the law that facilitate this activity need to be corrected. We believe that legislators need to look at the effects as well as the process; that the degradation of healthy, competitive firms needs to be stopped; that the process of money-churning deal making should not be permitted to jeopardize our financial system and the local and national economies that depend on its integrity; that the "sweat equity" investment of employees and communities must also be adequately protected and rewarded.

The consequences of takeover activity extend far beyond securities markets and corporate boards of directors. But the law as now constituted, effectively sanctifies rape and pillage by a few, as long as stockholders are paid off with a sufficient premium.

In inviting us here today, this Committee has recognized that there are other concerns and issues to be addressed, and we thank you and commend you for this. To help highlight some of those issues and concerns, I would like to describe our own recent experiences involving some of our largest employers.

In just the last twelve months, Safeway Stores, Lucky Stores and now within the past month, Supermarkets General, have been sucked into the corporate raiding game. Taken together, the UFCW represents roughly 150,000 people working at these firms. I believe our experience with each is instructive for the purposes before us today. I would like to describe each in turn and then draw from them the lessons they provide in common, and what they suggest to us with respect to legislative action.

First some background information. The UFCW by history, tradition and belief has been a decentralized union, particularly in the retail food sector. UFCW collective bargaining in the retail food industry has traditionally been on a local geographical contract basis. The International Union is not party to these agreements. Several local unions in a given metropolitan area or wider geographical area may bargain jointly with a single employer or with a group of employers, constituting a geographical "master agreement." This has served our members well, and our employers have generally been comfortable with this situation, as it is reflective of and responsive to the economic environment of local communities. As you might expect, however, when one of the firms party to such master agreements gets involved in hasty "restructuring" and asset sales, as has been the case with Safeway and Lucky, all the other employers become vulnerable to the effects. As disruptive as the consequences are to a single employer and its employees, in this industry at least, the problems can quickly spread to competitor firms and their employees as well.

Safeway Stores

Safeway is a multi-national firm, operating supermarkets coast-to-coast in the U.S. and in Western Canada and also overseas. It has no other significant lines of business. The UFCW represents virtually all U.S. and Canadian hourly-paid employees outside of its distribution facilities, where the workers are members of the Teamsters.

Roughly one year ago, we noticed an unusually high level of trading activity in Safeway Stores' shares. Calls to security analysts who track supermarket industry stocks turned up a wide

range of speculation. Some of these analysts had the right hunch --or source-- namely that Dart Group Inc., owned and controlled by the Haft family, well-known as real estate and stock speculators but not particularly well-regarded as retailers, were buying with a view to launching a bid for the company.

Within days the Hafts announced that they had acquired in excess of 5% of Safeway and sought to meet with management to discuss acquisition. The stock market had mixed opinions as to whether this was a serious offer or yet another Haft ploy for greenmail. By the way, the Haft's investment advisors in this "play" were Drexel, Burnham, Lambert, whose operations are now under SEC scrutiny.

At the International Union level we immediately attempted, unsuccessfully, to meet with top Safeway management to learn how the company intended to proceed, in order to be able to protect our members. It became clear that the company would go its own way in responding to the takeover threat, without consulting the union. The union then interviewed numerous lawyers and investment bankers knowledgeable in applicable securities law and practice, in order to learn the ground rules and possibilities of the takeover environment, and to develop options to respond to whatever the company or the Hafts might do. As you can imagine, learning about the world of banking, finance and stock market manipulation was, for us, almost like visiting a foreign country. There was a whole new language to learn (one that has been described as being like that of medieval warfare) - and a whole new set of rules, players and patterns of behavior. But we learned quickly, because we very quickly realized that the livelihoods of thousands of our members could well be up for grabs.

Our internal analysis suggested that the likely company response to the Haft bid would be to find a "white knight" and/or structure a leveraged buyout to take the company private. Ultimately Safeway went to Kohlberg, Kravis & Roberts who did both. The deal required burdening the surviving company with an extraordinarily high debt/equity ratio, even by the loose standards of current practice. The company's indebtedness has gone up five fold while its asset base has shrunk. No new facilities or jobs have been created in this process, and in fact what we can anticipate, in many areas, is replacement of decent-paying jobs with low wage casual employment, as marginal operators buy up the assets Safeway puts up for sale.

Even before the company issued its final Prospectus it had become clear to us that ultimately, even after disposing of its non-U.S. operations, significant amounts of U.S. and Canadian-based assets would have to be sold off to pay down the debt. Cash flow from operations would not be sufficient to pay the interest expense. Let me stress that all this was educated reasoning on our part as we watched the company maneuvers during the summer of 1986, cut off as we were, from their projections and deliberations.

Throughout this period the union's principal concern was to attempt to anticipate and prepare for the consequences of a possible Safeway bankruptcy and to preserve our members' jobs, wages and benefits and the union status of the markets in which Safeway operated. In many areas with multi-employer contracts union members enjoy portability of seniority for pension credits and the union(s) might be able to negotiate preferential hiring for Safeway members in the event stores were sold to other employers party to those multi-employer agreements. Also, we have found that workers' earnings come under serious attack, when and where the unionized share of the market drops dramatically because an employer decides to withdraw from that market area. That eventually has a snowball effect, leading to a general community-wide deterioration of incomes and economic vitality.

Without any enlightenment from the company as to what their plans might be, our local unions still had the task of renegotiating contracts that were expiring during this period. Rumors were rampant, workers' morale plummeted - and we got busy drafting contract language and an action program that we felt, when implemented by our local unions, would be our best shot at stabilizing and controlling a process whose full dimensions we could only guess at. The situation was further complicated by the fact that many of our members who felt themselves most vulnerable - because they lived and worked in areas that were suffering economically such as Texas and Oklahoma - had in the recent past taken substantial wage and benefit cuts, expecting that that would stabilize their job prospects. They felt betrayed and compromised.

Meanwhile, as the dust began to settle on the Safeway/KKR deal, the Hafts, who had "lost" their bid for the company, went home with $150 million in greenmail, nicely bankrolled for their next effort. The lawyers and bankers went home with another $150 million in fees. Safeway's top management had had their own jobs secured and had been cut into a 10% equity interest in the deal. The rest of the company's labor force became vulnerable sacrificial lambs. Terminations started with middle management -- usually on 24 hour notice. These people, who for years had been relied on for their loyalty in implementing company policy, and frequently doing the dirty work, in the hundreds picked up the phone and called us - because they recognized that only a union was in a position to understand what they were experiencing and to find a way to look out for employees' interests.

We carefully tracked the business press coverage of the leveraged buyout deal Safeway was working out with KKR and scanned the SEC filings as they became available. We became convinced that the likely future for Safeway employees was as follows: substantial numbers would lose their jobs as KKR sold off assets to pay down the enormous debt. But their ability to raise enough cash that way was questionable: if they sold stores in market areas where real estate values were good, they would lose earnings. In the markets where earnings were non-existent or mediocre, real estate values were down. That meant that they

would become increasingly ruthless in their demands for wage and benefit cuts and that there was a good possibility that the concessions our members had agreed to in the past, in effort to hold onto their jobs, would effectively be handed over to the banks and bondholders. This prognosis has regrettably proven to be all too accurate.

Accordingly, we filed suit in the State of California where Safeway is headquartered, asserting claims under the state's fraudulent conveyance law, which prohibits firms from intentionally bankrupting themselves. The purpose is to assert and establish the rights of Safeway employees as primary creditors, should the surviving firm ultimately go bankrupt. These claims include among others, wage and benefit concessions previously granted through union negotiation under the understanding that such concessions were needed to assure and protect the employees' jobs, and could be restored once financial pressure had eased. At present that suit is in Alameda District Court and to date the union has prevailed in Safeway's challenges to the suit. I call this to your attention because there is nothing comparable in the federal code that addresses the financial integrity of the corporations that are being restructured as a result of corporate raiding activity.

Meanwhile, Safeway has continued to rebuff union overtures for high-level meetings to work out an orderly response to the needs of the restructured company. As we perceive it, and as we anticipated, the shots are being called by KKR, whose overriding interest is raising as much cash as quickly as possible solely to pay down the debt, not to position Safeway as an effective competitor in the highly competitive supermarket industry.

At this very moment, UFCW local unions are in negotiations or preparing for renegotiating their agreements with Safeway, not knowing with any certainty whether or to what degree any or all of the stores in which our members work, are on KKR's "hit list," -- a list whose dimensions and structure are determined by the needs and standards of banks and their imposed financial covenants.

While the company did finally -- in November -- give us a list of general market areas where they would stay in business, others that they would pull out of and others where the decision depended on what kind of wage and benefit cuts they could get -- in fact they have targeted stores to be sold off in all market areas. Often we first find out about expected store closings in the trade press or via the grapevine. At this point in time we estimate that a minimum of 15,000 Safeway employees will have lost their jobs by the time the process winds down, and assuming the company does not in fact go bankrupt. We cannot estimate how many more will have been forced to accept substantial income cuts, as KKR tries to fund the debt out of the hides of the company's employees.

The company's notion of negotiating about sale or closing of stores is to demand cuts of $5-6 an hour in wages and benefits from people whose total compensation is generally in the $12.00 an hour range and who work considerably less than a 40-hour week. In effect, KKR is saying that the "new" Safeway can only meet its debt and interest obligations by paying its surviving employees poverty level wages. The difference between that and what it was able to pay its employees before the Hafts and Drexel, Burnham, Lambert threw it into the stock market maelstrom, is ransom demanded by banks, insurance companies and speculators.

Perhaps one of the most frustrating aspects of our experience of this process is not being sure, from day to day, where and how hard the company is going to land on its employees. In its final Prospectus filed on November 3, 1986 Safeway/KKR stated that "all or substantial percentages of the stock or assets of certain subsidiaries will be sold in order to generate cash to reduce the amount of the Bank Financing...no assets have been identified for sale..." Given the structure of this $4 billion deal, we find it hard to believe that the banks and other investors that had to be lined up before a tender offer of this sort could go forward, had not been apprised of how much KKR/Safeway expected it could raise from asset sales, and from the sale of which assets. Yet this information was not provided to Safeway stockholders, to the communities in which these assets were located, nor to the company's employees. Since that time, Safeway has gone from UFCW local union to UFCW local union with this blackmail weapon in its hand. Workers who took pay cuts in the past on the promise that that would bring job security, can no longer afford to consider the proposition any more, even if they had any faith left in the company's commitment to them. In our view, what we are experiencing is a direct transfer of wealth and income from Main Street to Wall Street.

The U.S. economy has gone through this before: in the 1890s and 1920s. The consensus of legislators, historians and economists has been that this is not good and not healthy and in no way conducive to steady and strong economic growth. Certainly in the narrow realm of the supermarket industry, there is a particular irony. As a service industry in which customer contact and customer acceptance is widely acknowledged to make or break a firm, it is much harder for supermarket firms to prosper when their employees are disgruntled or otherwise unsettled. But that is exactly what KKR has contributed to a firm that used to take great pride in its employee relations policies. We have experienced a similar transformation with Lucky Stores, the second case we bring to your attention.

Lucky Stores, Inc.

Lucky Stores, Inc. operates supermarkets on the West Coast of the U.S. and in the northern mid-West. It formerly also had supermarkets in Texas and Pacific Northwest, but these had been closed and sold by 1985. Although strictly U.S. based, it has had other lines of business: large general merchandise discount stores with a supermarket-type food section (Gemco on the West Coast) and specialty retail chains (auto supply, fabrics).

While Safeway was still being pursued by the Hafts, in the course of a meeting with Lucky Stores' senior management, we asked if they were concerned about raiding in the industry and what they were going to do about it. The company said it had no such concern. Ten days later, raider Asher Edelman announced he had 5% of the stock and would seek to acquire the firm.

Lucky took a different approach. While otherwise ignoring Edelman's bid, it decided to restructure itself and buy back its stock, pack its by-laws with "shark repellents", contending that all this would raise its market price high enough to discourage hostile raids. To raise cash it decided to sell off all but its core food business and, again, to increase its debt substantially.

Again the company rebuffed union overtures for a cooperative approach.

In this case too, the intense pressure to raise cash quickly, dominated all other concerns. Between mid-September and mid-October the company negotiated the sale of the Gemco stores employing 14,000 UFCW members. The Gemco stores were closed and UFCW members in the general merchandise sections of the stores lost their jobs. Dayton-Hudson, the buyer of the Gemco stores, will not recognize or honor the union contract and is not legally required to do so, since the stores were closed. Unless the union can prove discrimination, Dayton-Hudson is free to hire an entirely new labor force, most of whom are likely to be paid the minimum wage or less.

Every community in which Lucky had one of its 84 Gemco stores will now be that much poorer when Dayton-Hudson reopens them with a payroll cut in half. The new employees will have fewer dollars to spend in the neighborhoods and the difference will flow back to Dayton-Hudson headquarters.

In our view, Lucky went into a panic mode as soon as it found itself to be as vulnerable as Safeway. The people at Lucky headquarters in California decided that their job was to increase "shareholder value" -- i.e., the price at which the stock trades on the exchanges -- to make it too expensive for a greenmailer to launch an effective bid. Accordingly, they went deeply into debt in order to buy back 40% of their stock and implemented corporate by-law changes providing lesser voting rights for holders of large blocks of stock. With respect to internal operations, they set some uniform target rate of return for all divisions, irrespective of the local environment. In the case of the mid-West Eagle Division, the supermarkets are located in areas devastated by the collapse of the farm economy and heavy manufacturing. Despite this hostile environment, the division's profit ratios are comparable to industry norm, and in some localized areas substantially outperform the industry. Nonetheless, that was not enough for headquarters, whose performance standard is now being set by bankers who have no

knowledge of or interest in the vicissitudes or constraints of operating food stores.

Lucky approached twelve separate UFCW local unions with massive demands for concessions in its Eagle Division. It threatened to close the entire division, first demanding and then threatening to implement unilaterally, mid-contract 7% wage cuts from people who six months to two years earlier had already given substantial amounts back to the firm. The unions filed charges alleging violations of labor law and practice. Again employee morale plummeted and store operations began to suffer. Thankfully, the company came to its senses and just within the last few days rescinded its wage cut threats. We are hopeful that we will all now be able to move forward in a more constructive atmosphere on a basis of mutual respect and understanding.

Meanwhile, the company's stock price has fallen and it has had to cut back its capital investment program -- vital to success in the highly competitive supermarket industry.

We now have a third case, Supermarkets General Corporation, which has received notice from the Hafts that they own 5% of the firm and would like to discuss acquisition. The greenmail money that they made on the Safeway ploy has clearly come in handy.

While Safeway had played to mixed reviews on Wall Street, it had successfully and steadily improved its operating results in recent years (in part because of wage cuts extracted from our members); Lucky and Supermarkets General are and were highly

The CHAIRMAN. Mr. Hatfield.

STATEMENT OF JAMES E. HATFIELD, PRESIDENT, GLASS, POTTERY, PLASTICS AND ALLIED WORKERS INTERNATIONAL UNION

Mr. HATFIELD. Thank you, Mr. Chairman.

I suppose the best way for me to describe our testimony—it will be in the record—is that we represent many displaced workers in the glass industry. Owens-Illinois and Owens-Corning Fiberglas are the two companies we're talking about.

In order for you to understand, Owens-Illinois is the largest and the greatest glass company in this world until recently, the most productive. They started 10 to 15 years ago increasing their efficiencies, putting in new machinery. They are the most productive and most efficient company in the world—in research, you name it.

Owens-Corning Fiberglas is also a giant in the fiberglass industry of which we represent the majority of the people. Until just recently, a giant, an international company, the most productive, OCF had the greatest research ability. They were the ones that commercially developed an Owens-Illinois, discovery, fiberglas. Owens-Corning started in 1950 and they continued to produce and have the research which made the fiberglass industry in the position they are in today.

The thing that happened is that one company—Owens-Corning—fought off the raider, and Owens-Illinois accepted. There is no difference at the bottom line. And if I can try to explain the Wickes situation and our testimony, here they come out of a bankruptcy situation. Again, they owned the Owens-Corning Co., Manville, Certainteed, and other building suppliers huge sums of money and they settled about 10 cents on the dollar.

Now where I come from, we pay our debts. And then I guess the most frustrating thing for our people is that someone that didn't pay their debts for the products that we supplied them came in and destroyed the company in about 6 weeks.

COMPANY $2.6 BILLION IN DEBT

Mr. Chairman, the company is still entrenched, but now they have a $2.6 billion debt. It is so frightening that they are going to close plants, sell plants, terminate production, and reduce by half its research and development activities. Forbes magazine reported that OCF will reduce its manpower by 46 percent. It is staggering.

Wickes then walked away from this big fight with $30 million. We are going to lose 800 members in Barrington, NJ. They are going to close a plant in Tennessee. They are going to close their efficient and profitable operations in aerospace, reduce its range and scope and operation, and in the process, within months, its work force will drop from 28,000 people to approximately 13,000.

But more importantly is that the Owens-Corning Fiberglas Research Center will be reduced by 50 percent in Granville, OH. In the short run, they will meet their heavy obligation, but in the long run, who knows?

The question is, where will America find the fiberglass of the future? Not at the new Owens-Corning, that is for sure.

In Owens-Illinois, Kohlberg, Krauis and Roberts took over. The same thing will happen. The same results. They will lose the forest product division. They will close additional plants. They will probably close by ⅓ and reduce their activities and in their corporate office their staff by about 20 percent in addition to what they have cut over the past 5 years.

We represent 11,000 people there. We think it's unfair that we continue to permit this to happen. We in the American labor movement believe in the free enterprise system. However, we believe that corporate America has a multiple responsibility to its stockholders, employees, products, customers, and their communities.

Corporate America has a responsibility for providing jobs for Americans and for helping build a stronger America. It is our view that it is greed.

Congressman Gephardt recently said that the people who play in the merger game produce nothing, invent nothing, grow nothing, service nothing. I see my time is about up. We have again indicated to you in our testimony that we don't believe that what's happening in our industry is beneficial to our people. We are not here to criticize. We are here to ask that we improve and tighten up on the proposition that Mr. Icahn brought in, for example, in Owens-Illinois and then he backed out for $5 million. He bought into Anchor Hocking and he backed out for $3 million. He said he wouldn't buy any stock for the next 10 years. That's very nice, isn't it. But we have to make a lot of bottles, Mr. Chairman, to pay off those millions of dollars.

CANCER IN CORPORATE AMERICA

In closing, let me say that we feel, representing the little people in America, there's a cancer growing that will destroy us from within. We have a Federal deficit. We have a trade deficit, but what's happening here is it's destroying our industrial base. We feel the legislative body is responsible to police and keep faith in our own institutions and systems.

There has to be something wrong with our society when a few millionaires want to play a checker game and destroy so many benefits and we just think they are bastardizing the system and, in closing, I live in Pennsylvania, I cross the State frequently as well as cross this country. When I visit those small towns I look at the faces of the people. I see that they have lost faith in our system and I see that they have no hope.

I hope, Mr. Chairman, that we can revitalize this country and not let a few people destroy the greatest industrial base, the greatest country in this world.

Thank you very much.

[The complete prepared statement of James E. Hatfield follows:]

regarded in the investment community as efficient and profitable firms. Yet they have not been immune to attack from people who have figured out how to extract substantial sums of money by manipulating the rules of the stock trading game, if not through calculated extortion.

Our members, however, are now alert and will not play the game of helpless victim. On Monday 25 busloads of UFCW members employed by Supermarkets Gneral came down to Washington to convey their concerns to the Hafts and to their Representatives and Senators. We put you on notice, that we have only just begun to make our voices heard.

As workers' representatives, we are not rigidly opposed to mergers, divestitures, internal corporate restructuring, when these kinds of undertakings strengthen the operating ability of an enterprise. That kind of restructuring is good for earnings stability, and therefore job security as well. At the same time I think it is very important, especially for those charged with designing public policy, to recognize that much of the corporate restructuring going on today has nothing to do with questions of operating efficiency and performance. Instead, many of the changes of ownership and control of firms and their assets are responses to or consequences of stock market speculation and related forms of "money churning," in which millions of dollars in assets and "payoffs" such as greenmail, golden parachutes, etc., are taken out of healthy firms regardless of the consequences for operating efficiency and performance. Many of

the best business minds in this country are now devoted to "get rich quick" schemes of this sort, rather than the building up of strong firms.

Unlike some workers in other industries and sectors, the restructuring that the employees of these firms have gone through is not in response to foreign competition or similar factors that one could argue are outside the direct control of corporate management. In our experience, the costly and debilitating turmoil which I have described to you has come from within our own corporate system and from the greed and ingenuity of those in a position to manipulate its levers. In each and every instance, top corporate officers have been able to insulate their personal and financial situation from the turmoil and disruption they inflict on everyone else.

Having lived through two recent corporate raids, and coping with a new one in its early stages while trying to control the damage from the first two, we have a number of observations and suggestions for legislative reform. We trust the Committee will give them serious consideration.

The provisions of the law that set the rules for stock acquisition and public notification clearly favor outside raiders and penalize employees and their communities. This imbalance needs to be corrected. Along with many others we favor the following changes:

(1) Slow down the takeover process:

-- substantially reduce the threshold percentage of stock ownership which triggers filing of a disclosure statement ("13D" filings)

-- eliminate the 10-day delay now permitted between the time the threshhold is reached and the time the disclosure statement must be filed

-- any party filing a disclosure statement declaring that the stock acquisition is "for investment purposes only" should be barred from making a tender offer for some significant period of time

-- require a formal tender offer for 100% of the shares from any person or group who acquires some target percentage of a firm over some fixed period of time

-- extend the period of time that a tender offer must remain open; this gives management and other parties-in-interest more time to evaluate the offer and possible alternatives and would help reduce the panic element and the stampeding of stockholders

(2) Correct current biases that favor the hostile raid:

-- tighten the definition of a "group" for the purposes of 13-D filings to include parties and persons acting in concert "in effect"; this would help restrain the ability of deal makers such as KKR who have amassed billions of investment dollars through the use of "blind pools" of investment funds put in their hands by institutions such as insurance companies and pension funds

-- require that stockholders eligible to vote on a tender offer must have held their stock for more than one year. This would curb the ability of arbitrageurs and others with no interest in the firm as an operating entity, to control the outcome of tender offers

-- require some improved standard for showing of financing commitment for tender offers. Current vague "highly confident" statements available from banking houses for a fee are too vague and loose.

(3) Prevent profiteering by "unsuccessful" raiders:

-- prohibit the payment of "greenmail"

-- prohibit two-tier tender offers

-- recapture short-term profits made by "unsuccessful" raiders

(4) Protect the rights and investments of employees and communties

-- require that the terms of employment contracts voted by boards of directors for incumbent management in the event of a "change in control" ("golden parachutes") be provided on comparable pro rata terms to all employees

-- assert the responsibility of public corporations and their directors to consider the interests of parties other than stockholders -- particularly employees and their communities -- in evaluating tender offers or designing internal recapitalization programs

-- provide successorship protection for employees with contractual rights

-- safeguard pension plan assets from unilateral "recapture" by successful bidders, or by firms undertaking internal recapitalization

(5) Increase disclosure requirements for tender offers and stock repurchase or other recapitalization plans:

-- require bidders to disclose the principal supporting assumptions underlying their projections and asset valuations

-- require that outside makers of tender offers and/or incumbent management submitting a self-tender offer be required to share their business plans and asset valuations with representatives of employees and potentially affected communities as soon as a tender offer has been publicly filed

-- apply the same disclosure requirements to cash tender offers and exchange of securities offers

-- require advance notice to affected parties (customers and suppliers, communities, employees) of any intended asset sales

-- require disclosure of the projected impact of the deal on the offeror's stockholders as well as on the surviving corporation

(6) Limit vulnerability and exposure of publicly protected financial institutions to excessively leveraged deals:

-- establish legal liability for fraudulent conveyance for banks that participate in financing highly leveraged change of control transactions

-- limit holdings of below-investment grade securities by publicly chartered or insured financial institutions to some defined percentage of their total assets

I realize that this is a considerable legislative agenda, but we in the UFCW believe the current situation merits this level of attention. One has only to consider the fact that it was predicted towards the end of last year that tax reform would chill takeover activity. Then it was predicted that the insider-trading scandals and SEC investigations would slow things down. I think all those commentators failed to appreciate just how much money there is to be made in this game, and how many players have been seduced by the promise of quick, high-returns to loose money. These are not problems that will cure themselves, nor can we expect Wall Street to regulate itself out of massive payoffs. Reform can only come from legislative action.

Thank you.

STATEMENT

made by

JAMES E. HATFIELD, INTERNATIONAL PRESIDENT
GLASS, POTTERY, PLASTICS & ALLIED WORKERS

to the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

on

APRIL 8, 1987

Thank you for this important opportunity to convey our views and recommendations concerning corporate mergers and acquisitions. As you know, the past few years have seen an exceptional number of mergers and acquisitions - over 600 in the first 10 weeks of 1987. Thirty-three hundred mergers and takeovers occurred in 1986. Our International Union has been first hand witness to the unfortunate results visited upon corporations and their employees as a result of these corporate transactions.

Recently, in the summer of 1986 the Wickes Corporation attempted to gain control of Owens-Corning Fiberglas. Wickes had only recently emerged from the protection of the bankruptcy court. In fact, Wickes was then seeking to purchase a former creditor, OCF. As was widely reported, OCF fought the takeover bid and beat Wickes. OCF management retained control of the company. The cost to OCF was an incredible $2.6 billion debt.

This is a large sum. Interestingly, in 1985 alone, over 139 billion dollars was spent on mergers and acquisitions. Unhappily, one must note that these funds are not allotted to truly productive use. Let me note in passing that when management takes a company private through a leveraged buyout, enormous debts and pitfalls lie ahead. John Shad, chairman of the SEC wrote in the **Wall Street Journal** in 1984: "The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow." Furthermore, none of this enormous wealth goes to create jobs, industrial capacity or productive development. The money enriches the few, at the cost of the many.

To return to the OCF example, the 2.6 billion dollar debt has required a new corporate strategy. Some might say that it is a retreat. OCF has announced that it will close plants, sell plants, terminate production of certain items and reduce by about half its research and development activities. Forbes Magazine reports that OCF will reduce its manpower by 46%.

The CHAIRMAN. Thank you very much, Mr. Hatfield. I might say that I have the same kind of a fellow feeling for you that Senator Heinz has. He's my Senator. My grandfather was a glassblower in Pennsylvania who left Pennsylvania in 1870. That was a few years before your time, I take it, almost 120 years ago. I was very proud of my grandfather. He was known as the strongest man in Pennsylvania. Of course, that was before John Heinz. [Laughter.]

Mr. Sheinkman, go right ahead sir.

STATEMENT OF JACOB SHEINKMAN, SECRETARY-TREASURER, AMALGAMATED CLOTHING AND TEXTILE WORKERS UNION

Mr. SHEINKMAN. I want to echo and add a different perspective from a different industry, which is the textile and apparel industry and deal with some of the issues that were touched upon in the previous questioning, and I would like that my formal statement be admitted with 2 corrections.

The CHAIRMAN. Without objection, it will be printed in full with the corrections you would like to make.

Mr. SHEINKMAN. The corrections are, (1) we refer to the Levi Strauss-Dan Rivers as takeovers when they actually are LBO's and I'd like that corrected.

IMPACT OF LEVERAGE BUYOUTS AND TAKEOVERS

I would like to point out that there's a great deal of discussion and the buzz word in the United States today and particularly down here in Washington is competitiveness. We have a textile industry that has been productive to the tune of about 3.5 percent, which is double most manufacturing in the United States, and let me tell you the story from a different perspective, of what happens with leveraged buyouts and what happens with takeovers.

You had the Reeves Brothers Co., which operates in providing materials for the automobile industry as well as for the defense industry, doing about $450 million a year, going private in 1982. Prior to that it was investing some $14 million a year in capital improvements. Subsequent to the leveraged buyout by the then existing management, it started investing to the tune of some $7 million a year. Then in 1986, it gets acquired by Schick and what happens there is the banks put two limitations on—one limitation and one restriction. One is that they can't invest more than $10 million a year and they're in hock—Schick is in hock to the tune of $120 million through these nine banks. And it also says as part of the agreement it will require the termination of plan—do its best efforts to help liquidate that debt to the tune of $20-some-odd million.

And were it not for the fact that we were in the picture negotiating a contract, this matter probably would have not made any public attention whatever. They would have applied to PBGC. The matter would have been entirely silent. And the public at large would have been left ignorant of this kind of abuse taking part in terms of the banks.

Now it's interesting in the hearings that were held several weeks ago, in terms of what the response of Drexel Burnham was, the king of the junk bonds in these 9 banks. Drexel Burnham's position was that it wasn't a party to this arrangement. The bank said the borrower and the financial adviser, who happened to be Drexel Burnham, put that requirement in.

Now let's put it in human terms. Prior to these leveraged buyouts in 1982, the company in its information to its employees said it's going to guarantee these pensions, any benefits made as a result of gains in the market will go to the benefits of the employees because these are in effect deferred wages. They receive preferred treatment under our tax laws. The investors who invest pay no taxes on any gains that they make whatsoever to the U.S. Treasury.

And what happens is you have two employees. One, consider Oureen Jones, who will be retiring in 5 years. Her father worked for this company before. When he retired he got a pension of $28 a month. She in 5 years will be receiving a pension of $126 a month. That's $4 a day plus her Social Security. Were it not for the proposed retirement and liquidation of this pension plan and the gains made, this individual who will be retiring in 5 years could have an opportunity to obtain a greater pension and her father who retired in the past might likewise, if the company so deemed and if we were not in the picture, I say to you, to the members of this committee, this is what would have happened.

Let me also point out that this morning I was riding down on the shuttle and USA Today said that Burlington Industries is not a possible takeover target, the largest textile manufacturer in the United States. It was pointed out that the stock which is now selling above book value and gradually rising, that in terms of a takeover, its actual breaking it apart would create a greater value. A greater value to whom? A greater value to our society in terms of having people employed? A greater value of adding to the productive capacity of this Nation in a highly productive industry?

Then let me tell you the case of a nonunion situation. What happened with Bluebell. 1985, this is the headline in the industry paper, "Leveraged buyout, greenmail leaves Bluebell's pockets bare." The combination of a $65 million write-down, payment of $145 million in greenmail, a $413 million increase in debt from a leveraged buyout, and a slowdown in the jeans business has transformed Bluebell, Inc., from a well-financed manufacturer to one with a marginal net worth and most of its assets subject to creditors' liens.

This, I daresay, is what most companies will be facing in a downturn in the economy

I would like to also, in closing, support the statements of secretary-treasurer Donahue and my colleagues here, brothers Wynn and Hatfield, and just make the following comment. Reinvigorating American competitiveness will not be an easy task for companies, workers or our Government. To compete effectively, America needs a modern transportation network, stepped up research and development, and a trained and committed work force. And I daresay to this panel, what kind of commitment can workers have to the companies they work for not knowing whether they will be out of a job one day or the next?

And we find out what's happening and we therefore support the recommendations made by secretary-treasurer Donahue and I add the following. Not only an increase with respect to the tender offer period requirements and sales of blocks of stock in excess of 1 percent of a company's holding, the shareholder opportunity, the golden parachutes and likewise. And this I daresay for textile workers in North Carolina or shirt workers in Maine, the problem is the same whether they work in the textile industry, in the glass industry or in the retail industry. We're all plagued with the same problem and we have to decide as a nation what our course of conduct will be in the long run.

Thank you Mr. Chairman.

[The complete prepared statement of Jack Sheinkman follows:]

Why are all these actions taking place? To fund the debt incurred during the takeover fight.

Wickes Corporation emerged from the fight with a $30 million dollar profit. When the Goldsmith organization failed to gain control of Goodyear Tire and Rubber, it earned $160 million.

I ask you what social good was produced for the employees of Owens-Corning Fiberglas or Goodyear or the communities that are bases for these concerns.

When OCF closes its operation in Barrington, N.J., 800 members of the GPPAW will lose their jobs, as will 200 management employees. When Goodyear Tire and Rubber closed a plant in Akron, Ohio, 1600 employees went jobless. The excessive need for immediate cash flow without regard to future growth or development is responsible for this self-cannibalizing of assets.

OCF will close its Barrington, N.J. plant and its Jackson, Tenn., plant. It will sell its aerospace operation. It will reduce its range and its scope of operations and in the process within months its workforce will drop from 28,000 people to 13,000. Terribly significant, too, is Owens-Corning Fiberglas's radical 50% cut at its Granville, Ohio, research center. What was once a research and development based company is now essentially tied to the status quo.

In the short-run OCF will meet its heavy obligations. In the long-run, who knows. Forbes Magazine concludes its study of OCF with a question and an answer:

"Where will America find the fiberglass of the future? Not at the new Owens-Corning, that much is sure."

This sober assessment spells out a major flaw in present corporate practice. For how long can our nation compete in any market if future development is pushed aside to provide funding for merger and counter-merger activities.

In 1987, another major company under contract to the GPPAW has undergone a buyout. Owens-Illinois, the world's largest glass company, has been taken over by Kohlberg Kravis Roberts & Co. We now begin to see an emerging corporate strategy remarkably similar to that of Owens-Corning Fiberglas.

Owens-Illinois has announced its plans to sell its Forest Products Division. Plant closings are forecast. We anticipate employment reductions at Owens-Illinois of one-third to one-half of the present workforce.

The GPPAW represents over 11,000 employees of Owens-Illinois and, consequently, we are very concerned about the company's plans.

As at OCF some few people are going to make a lot of money. Top managers, whether retained or not, typically do quite well with their stock options and golden parachutes. Arbitrageurs, corporate financiers, investment houses and financial legal counsel find the merger enterprise most profitable. As already noted, we consider the profits earned to be unfair when weighed against the damage done by merger and takeover deals.

However, if one travels to Newark, Ohio, where OCF has curtailed operations or to Cherry Hill, N.J., where RCA's new owner GE has decreed major employment cutbacks, the picture is far less positive. Owens-Illinois' employees are apprehensive as they consider the loss of good jobs, wages and benefits.

America is looking at the willful dismemberment of its productive economic structure. We are watching as good jobs are eliminated. We stand by as communities lose their industrial mainstays. What is to replace these jobs, this taxbase? What means will exist in a few years to re-build the "crumbling infrastructure" that only a few years ago was a major concern. We will soon have far less enterprise for our infrastructure to serve.

We in the American labor movement believe in the free enterprise system. However, we believe that corporate America has a multiple responsibility to its stockholders, employees, products, customers and their communities. Corporate America has a responsibility for providing jobs for Americans and for helping to build a stronger America.

It's our view that greed is the motive factor in the corporate merger and acquisition mania, the leveraged buyout strategy and the restructuring necessitated by them. Greed and, perhaps, the ego satisfaction of being involved in the biggest game in town motivate the dealmakers, but these motives are unacceptable on their face. The conception of mergers as a game is apparent from the jargon of the stock trade. A company is said to be "in play" when someone is bidding for it. The arbitrageurs and management are "players" and similar figures of speech abound. Unfortunately, the spectators are less like sports fans and more like innocent bystanders. And, as is commonly accepted, it is frequently innocent bystanders who get hurt.

I feel obliged to cite some remarks that U.S. Rep. Richard A. Gephardt made recently at the Securities Industry Institute of the Wharton School of Business. Congressman Gephardt said that the term economy traced to its Greek origins fundamentally refers to the well-being of a family. He went on to note that the high stakes merger game on Wall Street pays no attention to the well-being of either individual families or the social family in which we all belong. We in the Labor Movement feel that it is long past due for the needs of the people affected by mergers to be considered.

As Mr. Gephardt said, the people who play at the merger game "produce nothing, invent nothing, grow nothing and service nothing." The cost to our nation is immense.

However, by our comments we do not wish to imply any criticism of our economic system. In the main American companies, their managers and employees, and the products and services that they offer are worthy of respect. It is our desire to provide constructive criticism that will lead to improvements in the system.

Whether a takeover bid is successful or not has little bearing. The money crunch is so heavy that, win or lose, companies in play must incur debt, restructure, get "lean and mean" to use a phrase favored by the merger practitioners. Employees, their families, and their communities are the innocent bystanders injured during these transactions. It doesn't matter if OCF or O-I ward off their suitors or welcome them. The result for many workers is the same - the loss of jobs, careers and a secure future.

Historically, previous Administrations vigorously reviewed most mergers and in many cases disallowed the transactions.

Unless the Justice Department and the Federal Trade Commission begin to enforce existing statutes and regulations, the harm will continue and deepen. Already we see first generation mergers and leveraged buyouts going into a second stage. Takeover companies become targets and LBO's go public again only to become targets or players once more.

Improvements in the securities laws pertaining to tender offers and SEC reporting requirements would, we believe, be benefit to employees. Our experience in the OCF attempted acquisition is sorely on point. Because of the suddenness of the acquisition offer from Wickes as well as the restructuring response by OCF, the union and employees' opportunity for thoughtful and meaningful response was forfeited. If more time had been available for a response, we believe that the union and the employees might have crafted a thoughtful and reasoned response to the acquisition or restructuring.

Instead, OCF management, pressured by the Wickes acquisition attempt and its own shareholders, responded rapidly with a corporate restructuring.

We would therefore applaud all efforts which would lessen amounts of stock purchased before triggering reporting requirements as well as more timely and diligent reporting to the SEC. We believe that the present 5% stock acquisition threshold is too high. In Britain, a reporting threshold of 1% is enforced. We also applaud extensions of time periods for tender offers, as well as lengthened time periods before a corporate restructuring can be finalized as an answer to an acquisition offer.

We also strongly support FTC and Justice Department review periods being extended. We further believe the public economic impact statement should accompany such review.

Moreover, these recommendations while praiseworthy do not go far enough to deal with the root evil of such corporate activities.

Whether the merger involves banks, airlines, industrial plants, television network or retail chain, the policies of retrenchment and debt service remain paramount. While corporate inefficiencies undoubtedly exist, we question whether the wholesale dislocation of some of our most significant corporations is the way to create efficiencies. We did not come here today simply to recite the present ills. We have a number of recommendations to make that we feel would create a saner, more just economic environment. Our recommendations are as follows:

1. Require the Justice Department and Federal Trade Commission to vigorously enforce anti-trust laws.

2. Tax stock transactions registered with the Securities and Exchange Commission as elements in a takeover or LBO plan. Elsewhere we have called for and ask you to consider a 5% tax on large stock transfers. Such a tax would have two effects: it would serve to limit more speculative takeover maneuvers and it would provide needed relief revenues for affected employees.

3. Use tax revenues from stock transfers to fund an agency similar to the Pension Benefit Guaranty Corporation. Establish this agency to provide training, job placement assistance, guarantees of health insurance, relief funds to individuals and communities adversely affected by mergers, leveraged buyouts and related-activities.

4. Pass plant closing legislation requiring ample notification to affected employees.

5. Outlaw greenmail or tax it so heavily as to make it an undesirable speculation. Stock speculation on a massive scale is undermining our nation's strength and the financial security of many Americans.

6. Forbid companies emerging from bankruptcy the right to exercise takeover bids for a period of 3 years unless all of their former creditors are satisfied.

7. Alter SEC regulations to lessen stock acquisition reporting thresholds to a 1% level, lengthen tender offer time or periods and extend FTC and Justice Department review periods and procedures.

8. Create a review policy for determination of permissibility of corporate restructuring.

In closing, let me say that we in the Glass, Pottery, Plastics & Allied Workers recognize the many benefits enjoyed by everyone who participates in the free enterprise system. We recognize that part played in that system by entrepreneurs and speculators. We respect the risk-takers and the investors at the same time that we call for restrictions upon them. Ours is a complex society and a complex economy. We cannot ignore the unjust treatment of so many of our fellow citizens and the disruption and reductions of so many major enterprises without calling for measures that correct abuses of the system.

TESTIMONY OF JACK SHEINKMAN, SECRETARY-TREASURER OF THE AMALGAMATED CLOTHING AND TEXTILE WORKERS UNION, BEFORE THE SENATE BANKING, HOUSING, AND URBAN AFFAIRS SUBCOMMITTEE OVERSIGHT HEARING ON CORPORATE TAKEOVERS

APRIL 8, 1987

My name is Jack Sheinkman and I am Secretary-Treasurer of the Amalgamated Clothing and Textile Workers Union (ACTWU). I would like to thank this Committee for the opportunity ot testify on the effects of leveraged buy-outs on workers and their companies. My remarks will focus on the impact leveraged by-outs have in the textile and apparel industries. I will draw heavily on the example of a recent leverage buy-out of the Reeves Brothers Inc. textile company--a case which we believe epitomizes the need for urgent Congressional action on corporate takeovers.

Among the T. Boone Pickens and Carl Ichans of the world, it is fashionable to argue that the current spate of leveraged buy-outs improve economic efficiency, while enhancing shareholders' value. Corporate raiders would have us believe their victims are all badly managed firms. Their prescription is to slash bloated corporate staff, shut marginal plants and promote innovative products. As everyone's interest is served, government should stand aside and let market forces reign.

A corollarly proposition often advanced is that firms taken private over the leveraged buy-out road enjoy competitive advantages over their public counterparts. Private investors are said to be a cunning and patient lot, willing to wait long years to bring new products or technologies to fruition. The razor thin margin for error resulting from huge debt repayments concentrates management's attention on the essential tasks of

survivial.

Among the firms that I am familiar with, mainly in the clothing and textile industries, these arguments do not square with the facts. In these industries, decades of instense foreign competition have left little room for excess corporate overhead or inefficient plants. Productivity growth is one of the best measures of economic efficiency. In textiles, productivity increases have averaged 3.5 per cent annually over, the last decade, a rate nearly double that of the economy as a whole.

I wish to bring before this committee a compelling example of the negative impact leveraged buy-outs can have on a company and its employees. Our union is currently negotiating a contract with Reeves Brothers, Inc. Reeves is a 450 million dollar a year, diversified, southern-based, textile firm. It produces goods ranging from automotive parts for Chrysler and GM to knit underwear for the U.S. military. As a publicly-held firm Reeves built a host of new plants, expanded its markets geographically and moved aggressively into new product lines.

In 1982 Reeves went private in an LBO only to be bought out by Schick, Inc. in another LBO in 1986. Prior to 1982 Reeves invested as much as 13 million dollars in one year in new plants and equipment. Once it went private the company shut down factories and reduced its product lines. Capital investment declined to as low as seven million dollars per year. What has changed at Reeves? Certainly not management, as key executives are the relatives of the founders of this sixty odd year old company.

The CHAIRMAN. Thank you, Mr. Sheinkman.
Mr. Stone.

STATEMENT OF MILAN STONE, PRESIDENT, UNITED RUBBER, CORK, LINOLEUM AND PLASTIC WORKERS OF AMERICA

Mr. STONE. Thank you, Mr. Chairman.

I would request that the full text of my remarks be included in the record.

The CHAIRMAN. Without objection, the statement will be printed in the record.

PROBLEMS WITH HOSTILE TAKEOVERS

And I would like to relate to you that the problems that we face in our industry, while they are specific that we face in our industry, while they are specific to the rubber or tire industry, are not unlike those that are faced in the industries of my colleagues at this table and for the labor movement in general that secretary-treasury Donahue talked about this morning, perhaps we've had more of it for our size.

We have had problems with hostile takeovers in Goodyear, the largest one, about 6 or 7 months ago. In the last 3 or 4 years, the Firestone Co., the B.F. Goodrich Co., the Uniroyal Co. were involved with Carl Icahn at some point in time. Goodrich had to pay $34 million in greenmail to Carl Icahn.

In the case of the Uniroyal Co., they paid Icahn about $60 million I believe, somewhere in that area. They got involved in a leveraged buyout through Drexel Burnham and today there is no more Uniroyal Co. as such. There's been a merger of the tire plants with B.F. Goodrich, but Uniroyal Corp. no longer exists.

Gencorp, as secretary-treasurer Donahue mentioned this morning, is just going through the throes of a hostile takeover by AFG Group. They beat them off, like the others did, by paying them $74 million. I'd like to get beat like that a couple times a year. It's left the company, however, with the same program ahead of them that they had mentioned a couple days ago they were going to undertake, and that is the sale of some of their divisions, one of which the sale of their three tire plants in this country where we represent the workers. The backing away of the AFG Group this morning did not alter that. The tire plants will still be for sale.

In the case of Goodyear, where Sir James from England was beaten to the tune of $134 million is all that he received when Goodyear beat him, has left that company in a lot different form than it had been. We had had a very good relationship with the Goodyear Tire & Rubber Co. In fact, about ¼ of our members worked for the Goodyear Tire & Rubber Co. or its subsidiaries. We were able through our relations with them to convince the company that rather than build a new nonunion plant out in the prairie someplace that they should convert a plant where we represented the workers in Tyler, TX, to the tune of a $¼ billion. They could have built a new plant for about the same price. That plant is a world competitive plant and we did it working together—rubber workers and the Goodyear Tire & Rubber Co.

Because of what's happened and what Sir James Goldsmith has forced upon this company to try to maintain its identity, it will be much tougher in the future for us to do those things to protect jobs. We have had three plant closures that we're going through. We have a 6 month notification period in our Goodyear agreement so that we have three plants that are going through that. One is in Canada, in Toronto, where nonetheless the people are suffering as much there as they do in Cumberland, MD, just up the road here, where about 1,000 rubber workers are losing their jobs at the end of May.

Local 26 has been in existence for more than 50 years. The plant has been in existence since about 1921 and those people are losing their jobs because of corporate takeover.

A smaller plant, a footwear related plant in Vermont, is also closing.

And we will have the president of our Cumberland local union testifying to you here this morning.

You heard related the problems that the workers faced and that the community faced when these things happen to corporations and we have seen plenty of that suffering and plenty of the things that happen when these corporations go through those things.

So I would limit my testimony then this morning to echoing the support that my colleagues have here for those positions taken by secretary-treasurer Donahue and support the things and the changes and the adjustments that we need we believe to at least put us in a more level playing field and protect the workers and the communities where we represent them.

Thank you, Mr. Chairman.

[The complete prepared statement of Milan Stone follows:]

The same executives who ran this innovative publicly-held company were the ones who first transformed it into a privately held cash machine for the benefit of a group of banks and themselves, and then transformed yet it again to become part of a holding company. This took place all in the space of four years. This change has profited and continues to profit only the executives and their lenders.

National Westminster, Empire of America Federal Savings Bank, Sovran Bank, American Security Bank, Canadian Imperial Bank of Commerce, Bank of Tokyo and others make up a nine bank consortium which last May provided 120 million dollars in financing that permitted Schick to take over Reeves. These banks are now Schick's and Reeves' number one constituency. Through restrictions in the loan agreement they have assumed de facto control over the two companies' cash management; and cash flow is the critical factor to banks. The restrictions imposed by this loan agreement even limit Reeves' annual capital investment to ten million dollars. Add to this equation the other major source of financing for the takeover, Drexel Burnham junk bonds, and it is easy to see how an ownership group that was interested in both dividends and capital gains has become far more driven by quarterly interest payments.

Shrinking capital investment in the highly competitive textile and apparel industries when combined with huge fixed interest costs is a sure strategy for disaster. Our industry suffers from the business cycle to an extreme degree, and firms like Reeves Brothers and Schick will find survival problematic if the next recession arrives too quickly. Large, publicly-traded

firms can reduce their dividends to stockholders, but if Schick and Reeves miss an interest payment their bankers will be living in their house.

Beyond the missed opportunities for creating new jobs or the potential time bomb that may explode in the next business cycle is the daily impact a leveraged buy-out has on a firm.

One important weapon in every company's competitive arsenal is a loyal, productive workforce. Never entered on any firm's balance sheet, the human capital American workers bring to their jobs remains our principal competitive advantage in the world. Unfortunately, employees are given little consideration in the post-LBO environment. A typical LBO script would include carving out an entire level of middle management, early, forced retirements, plant closings, and layoffs for thousands.

After West coast financier David Murdock took over Cannon Mills, the work force was cut from 33,000 to 25,000 in four years. A takeover at Levi Strauss resulted in an employment decline from 36,000 to 33,000. The Dan River takeover eliminated 4,000 textile jobs and 1,500 Healthtex workers were dismissed as a result of a recent company aquisition

Today management is signaling the profound alteration of the corporate social compact in many dramatic ways. One ominous barometer is the rising number of pension plan terminations. Pension plans represent an implicit contract emphasizing a long term employment relationship. When employers strip assets from these funds they are indicating the devaluation of the long term loyalty of their employees.

Again using Reeves Brothers as a case study, we find that this company had promised its employees in numerous letters over many years that their pension plan had been set up to "help the participating employees build toward financial security at retirement." The company went even further and guaranteed that "the pension will increase through company contributions and gains on fund investment."

Despite such clear commitments, Reeves' current owners, apparently following the advice of its financial adviser, Drexel Burnham Lambert, are in the process of terminating its pension plans. Reeves potentially will recover 27 million dollars the bulk of which must be turned over to its banks; this termination was another key provision in the loan agreement that allowed Schick to purchase Reeves.

Two weeks ago Senator Metzenbaum and Congressman Clay held hearings on pension fund terminations. They requested the written comments of the nine banks and Drexel explaining this termination. Their comments would seem comic if they weren't so sad: Drexel stated, and I am quoting here, that it "was neither an agent under, nor a party to, the bank credit agreement." What do the banks say? They say that they would "never" propose terminations and that they were "present[ed] with loan proposals" by the borrower and their investment advisor. All this finger-pointing and blame-shifting indicates the unease that the parties feel for their unethical and unsavory conduct. I would also note the irony of these banks accepting the terminated funds even as they advertise the large number of pension funds they manage or are custodians of.

The impact of this type of pension fund raid as a direct result of an LBO is devastating to employees. Consider Oureen Jones. Oureen has worked for Reeves Brothers in Cornelius, North Carolina for 22 years. Her father worked in the same plant before her and Oureen's daughter works there today. Upon retirement Oureen's father got a 28 dollar per month pension. When Oureen retires in five years she will receive 126 dollars a month. I know that no one in this room believes that four dollars a day is an adequate amount for even the most modest retirement.

I would ask Reeves' current owners to explain to Oureen why nine banks have a stronger claim to the pension fund than she or her daughter or her father does. One can only wonder what lessons American workers are learning about the value of institutional loyalty in such situations. If we multiply the lesson the Jones family has learned across every factory and office, from the machine operator to the engineer, I can safely tell you the result will be a country filled with people distrustful of the benefits of loyalty to their companies and doubtful that their future holds much promise.

Leveraged buy-outs cause the worst sort of short term management psychosis. Ever cautious banks, interested only in the next loan installment, handcuff the corporation. The company's cash flow pours into the banks and junk bondholders' pockets rather than being used to build new plants or to develop new products. Wages, employment security, and benefits, are treated as so much corporate fat, rather than as long term investments in the human capital of the firm. On the other side, one can only wonder at the enormous waste of financial capital that takes place during the continuing shell game of buying and selling the best firms in a few healthy industries.

Reinvigorating American competitiveness will not be an easy task for companies, workers or our government. To compete effectively America needs a modern transportation network, stepped up research and development, and a trained and committed workforce. Education and infranstructure will require the expenditure of public money. In this era of runaway budget deficits it seems contrary to the national interest to allow firms to escape taxation through wasteful LBOs. The investment bankers who market LBOs stress to their potential customers the reduction of tax liabilities which in effect becomes the reward for taking on massive debt. If we allow firms to slash their tax liabilities in half we effectively shift capital resources from the public to the private sector. Our union strongly endorses the work your committee has undertaken today. We join the AFL-CIO in advocating measures which limit the unproductive accumulation of corporate debt and overleveraging from adverse takeovers. Such legislative efforts might well begin with curbing the use of junk bond capital in corporate takeovers. Individual investors are not permitted to purchase stock with margin accounts. Yet a leveraged buyout fueled by high risk junk bonds operates on this very principle. Tightening the margin rules on takeover debt will compel legitimate business deals to again be backed by real money.

The intrusion of destablizing leveraged buyouts in the textile/apparel industries underscores the need for a restructuring of the corporate takeover process itself. This process needs to be opened up, slowed down, and subjected to greater employee, shareholder, and regulatory scrutiny. Regulations increasing the tender offer peroid, requirements for the disclosure of takeover partnerships and the sales of blocks of stock in excess of 1% of company holdings are important legislative measures in this direction. Shareholders should be afforded greater opportunity to vote on substantive changes in the company resulting from takeover contests. This includes lavish "golden parachutes" for outgoing management and wasteful "scorched earth" management policies often brought into play to stave off hostile takeovers.

From the perspective of the workplace, legislation assumes a different urgency. For textile workers in North Carolina, for shirt workers in Maine, their encounters with takeovers and leveraged buyouts have resulted in the erosion of their job security and the productive future of their companies. They seek immediate protection from corporate takeover abuses which sap their workplaces of competative resources, divert funds for essential recapitalization, and, as in the case of the Reeves workers, rob them of pension assets necessary for their retirement security.

Statement of
MILAN STONE
President, United Rubber Workers International Union
to the
Committee on Banking, Housing and Urban Affairs
United States Senate
on
Hostile Corporate Takeovers
April 8, 1987

Mr. Chairman and Members of the Senate Committee on Banking, Housing and Urban Affairs:

My name is Milan Stone. I am President of the United Rubber Workers International Union. We represent approximately 110,000 workers across the United States and Canada. The URW is headquartered in Akron, Ohio where it was founded 51 years ago.

I want to thank this Subcommittee for scheduling this important hearing. The URW has previously presented its views on hostile corporate takeovers to the House Subcommittees on Monopolies and Commerical Law (two occasions--November 18, 1986 and March 26, 1987) and Employment and Housing (March 31, 1987) as well as to the Senate Antitrust Subcommittee (April 2, 1987). We welcome this additional opportunity to put our position before the Congress. I am especially pleased that this Committee has devoted the entire hearing to getting American Labor's point of view on this extremely critical issue.

The Rubber Workers unfortunately have had some recent first-hand experience with hostile takeovers. In view of that experience, I would like to provide you with the URW's perspective, particularly as it relates to The Goodyear Tire and Rubber Company where we represent some 25,000 workers. As you know, Goodyear fought off a hostile takeover attempt by Sir James Goldsmith late last year. Part of this statement is devoted to the costs of that somewhat Pyrrhic victory.

However, I do not want to deal solely with that particular unwanted and unwarranted advance. The question is much deeper and far broader than a single company or a single corporate raider. It is a problem that has grown in magnitude and scope to the point that the economic health of the entire United States is quite literally threatened. Virtually every day, newspapers are filled with stories about these nonproductive attacks against major profitable companies.

In the opening statement at a hearing held January 28th by this Committee, Senator Proxmire estimated that in 1986, the total cost of acquisitions--$150 billion--exceeded by $10 billion the amount American manufacturers spent on plant and equipment. To me, that sounds like a quick route to economic destruction.

The billions of dollars used to finance, as well as fend off, hostile takeovers is money that is consequently not available for investment to strengthen the U. S. economy. The money, time, effort and imagination that corporate managers are forced to devote to fighting takeover battles would be more wisely spent in manufacturing higher quality products and providing better services at a lower price to the benefit of all of our citizens.

Corporations are in business to make money and we want them to be prosperous because we expect to share in that prosperity. The activities of the corporate raiders, however, are not at all conducive to those objectives. Rather, we see corporate takeovers as a method to make enormous and obscene profits for the already rich without creating anything new in the way of jobs, products or enhanced competitiveness. They are, in our opinion, "sterile" transactions, a gross misuse of resources.

The world economy has never been so competitive as it is today. We face an enormous and rising trade deficit which simply means that not only are we having difficulty competing abroad, but we're having trouble competing in our own backyard.

Corporate America has been castigated, and I think rightfully so, for paying too much attention to the short-term bottom line at the expense of long-term competitiveness and thus future job security. There must be investment in quality, innovation and product development if corporate America and our high standard of living is to survive. As a Nation, we must make the necessary preparations to replace our aging equipment and facilities. We must invest in our future if we expect to have one.

Such a long-term philosophy, however, seems to be an invitation to the corporate raider who regards stock prices as the only proper measure of a company's success or failure and who sees a company with vision as an opportunity for a quick buck. The raider can step in, force a company to change its direction in response to a takeover threat and in the process reap millions of dollars through greenmail or through the systematic dismemberment of a company.

American corporations thus find themselves caught in a double-bind. If they put emphasis on short-term results and stock price at the expense of capital investment, research and development, they run the very real risk of losing their ability to compete over the long term. If they pursue a long-term growth strategy, the bottom line may initially suffer and lead to an undervaluation of the stock and a takeover threat. It can be a classic no-win situation.

That is precisely what happened to Goodyear as a result of Sir James Goldsmith's hostile takeover effort. We regard this as an abuse of wealth intended to benefit Goldsmith and his associates--no one else. I see no altruism in Goldsmith's actions, a statement with which I believe he would agree. He is in this to make money, pure and simple, and he makes money through rising stock prices or by selling off assets. In the Goodyear attempt, he netted $94 million when he sold his shares back to the Company at a premium. Goodyear also paid $37 million of his expenses. I find it hard to believe that there is any concern for the employees or the communities involved. Nor do I believe he is overly concerned with any shareholder other than himself, despite protestations to the contrary, a trait I believe he shares with other corporate raiders.

To fend off the takeover attempt, Goodyear restructured itself, a process that has thus far meant $4 billion of debt, the sale of certain subsidiaries to finance that debt and a cost reduction program that has resulted in jobs being lost and plants being closed.

According to the Company, when the restructuring is complete, Goodyear will be 12 percent smaller. Goodyear has already announced the closing of three of its plants and has recently said it may close more as part of its strategy to recover from last year's takeover bid by Goldsmith.

Two of the plant closures are tire plants in Cumberland, Maryland and Toronto, Ontario where the URW represents the hourly employees.

In Cumberland, over 1,000 Rubber Workers (Local 26) are losing their jobs. The Kelly-Springfield (Goodyear subsidiary) plant is scheduled to close May 21. Our members in that plant earn an average of $11.72 per hour excluding fringe benefits. Some $25 million of wages a year will be directly taken out of the Cumberland economy. Manufacturing wages generally multiply 6 or 7 times through the economy which means that the loss of the Cumberland jobs could cost the local economy $175 million annually.

Goodyear originally planned to move Kelly-Springfield's corporate offices out of Cumberland, but state and local government efforts succeeded in keeping most of the white-collar jobs in the area. Goodyear Chairman Robert Mercer had this to say on the interest on the new debt incurred as a result of the takeover attempt: "The interest.....is $200 million a year. We could have built a new plant with that money in Cumberland, Maryland. Instead, we're closing one down there." (Akron Beacon Journal, January 23, 1987)

In Toronto, nearly 1,400 URW members (Local 232) and roughly 200 white-collar employees will lose their jobs in about 6 weeks. Our members make $14.07 per hour there. When they leave Goodyear, $40 million (Canadian) will initially be pulled from the local economy which will ripple into a loss of some $280 million a year. This estimate does not account for the impact of the salaried personnel who will lose their jobs.

The third plant closing is a hose couplings plant in Menominee, Michigan which employed 150 people. This plant was not part of the URW.

In addition, the Company, just prior to the takeover attempt announced the closing of a shoe products plant in Windsor, Vermont. The URW has a six-month advance notice provision in its collective bargaining agreement with Goodyear which provides that the parties will negotiate to save a plant. The Goldsmith caper effectively precluded any chance of success in such negotiations and in my view, the Windsor plant must be counted among the casualties of the attempted takeover.

In Windsor, the 300 members of URW Local 289 earned an average wage of $9.50 per hour. The closing of that plant will mean the loss of about $6 million to the local economy. The multiplier effect will up the eventual cost to $42 million annually, exclusive of white-collar layoffs.

Other consequences of last November's raid include the loss of 80 hourly jobs in Akron (URW Local 2) with the short-term potential for 40 more and the negotiation of concessions at the Company's Gadsden, Alabama tire plant (URW Local 12) which are expected to provide some $20 million relief per year with half that coming from wage cuts. The two together can be expected to take a total of $72 million out of their local economies.

Local 2 also recently agreed to a collective bargaining agreement with Motor Wheel Corporation, the new company that bought the Goodyear rim plant in Akron. The sale of this plant was part of Goodyear's restructuring program. While the new contract maintains the previous wage level, it does not contain provisions for vacations, pensions or plant closure notification, items that were a part of the contract when Goodyear ran the facility. Employment at the plant is expected to decline from about 400 workers to 175 workers by the end of the year.

Salaried workers have also felt the effect of the restructuring. Some 600 Goodyear white-collar positions in Akron have been eliminated. All told, about 1,800 salaried personnel have been cut throughout the Goodyear system since the restructuring program began.

Goodyear's remaining employees' futures are far from secure, endangered by the decision to chop the research and development program by 7 percent and reduce capital expenditures by $275 million in order to provide cash to handle its new debt.

People are our bottom line. Where will these people and possibly many others find new jobs? The statistics indicate that getting a new job in this Country is often a lengthy process and that, in most cases, the new job offers less in wages and benefits than the old one. Consequently, the workers' standard of living is lowered; other businesses in the affected community stand to lose as their customers now spend less; the tax base of the community and the public services it is able to offer are likely to be cut. This is all part of the negative or reverse multiplier effect that ripples throughout the economy and touches the lives of many not directly associated with a plant closure or massive layoff.

The economic cost is enormous, but plant closures and indeed, enforced unemployment for whatever reason, present an even more terrible waste: the waste of our nation's most valuable resource--its people.

A definite relationship between unemployment and physical and mental illness has been clearly documented. According to the Institute for Social Research at the University of Michigan, plant closings are accompanied by increased incidence of arthritis, high blood pressure and ulcers among terminated workers. Psychologists and social workers have found noticeable increases in divorce, alcoholism, child beating, depression, drug abuse, suicide, criminal behavior and poor mental health

The **Chairman**. Thank you, Mr. Stone.

Mr. Sheinkman, in your testimony you provide an example of the egregious results of a hostile takeover in the Schick case.

How widespread are these problems and is this the rule or the exception?

Mr. **Sheinkman**. Well, I would say maybe sub silentio, or quietly, this may be done in many situations because I don't think everybody had the gall to put it down barefacedly into an agreement with the lenders. And I daresay that most of these banks or junk bond houses would not put that into an agreement that they knew was going to see the light of day and I don't think many people did think that.

But I daresay that this is being done in other situations and I don't think that it is a limited case.

The **Chairman**. Mr. Stone, you cite studies that show the fallout of hostile takeovers include divorce, alcoholism, child beating, depression, drug abuse, suicide, crime, and mental breakdown.

To correct that, you suggest several changes in the securities laws with which I agree. But given the magnitude and gravity of the problems, will the securities laws changes be enough to correct the profound psychological trauma wrought by hostile takeovers?

Mr. **Stone**. Well, I don't think that in itself will stop it. I think we need the protection of the things that were mentioned here this morning. That certainly would be one of the steps that would help to alleviate some of the suffering. Certainly it would not do it alone.

The **Chairman**. What did you have in mind particularly as essential for the committee to consider adopting as legislation?

Mr. **Stone**. Well, I think that the most important aspect of those requests that we made here, in my opinion, are that the successor provision of an agreement in whatever form we talk about, that whoever takes over a corporation has to run that corporation under those contracts that are in place when he buys it.

That certainly should deter the fast-buck artist I believe, and certainly will alleviate the suffering that people are put through.

PUBLISH ECONOMIC IMPACT STATEMENTS

The **Chairman**. Mr. Hatfield, you mention in your testimony that the Justice Department and the Federal Trade Commission should publish an economic impact statement in conjunction with antitrust rulings.

Some people might argue that these statements would slow the review process, that they would impede worthwhile takeovers as well as abusive acquisitions. Would such statements lead to delay and should such statements be required for every merger? If so, would these statements be costly and lead to a delay of good mergers?

Mr. **Hatfield**. I couldn't answer in the affirmative for all takeovers or mergers, but in the—particularly the case of Owens-Corning, the awesome pressure that was presented to that company by the Wickes Corp.——

The CHAIRMAN. Now how would they determine whether an economic impact statement should be required? What standards would you provide for the Justice Department?

Mr. HATFIELD. Well, I just think that we need more——

The CHAIRMAN. I think you have a good point, but I'm trying to see how we can work it out practically.

Mr. HATFIELD. I don't know, Mr. Chairman. I can only say that in the OCF case, if we had more time, it would have been more effective and maybe we would not have this position we're in today of taking a third of that company away. If you can just stall and not force this action as quickly as it's occurring, and all the information out on the table, it may have prevented this from occurring with Owens-Corning Fiberglas.

The CHAIRMAN. Of course, one of the steps being considered by the committee is to extend the tender offer period from 20 days so that the corporation being attacked in a hostile takeover would have more time to make their case. This is, I presume, one of the windows through which you might develop an economic impact statement.

Mr. HATFIELD. Anything in that direction, as in our No. 2 that we said also, that we call for and ask your consideration of a 5-percent tax on large stock transfers. We think that would also help. We have those recommendations in item No. 2 and item No. 3. We would ask that you consider those.

The CHAIRMAN. Mr. Wynn, you estimate that Safeway will terminate at least 15,000 workers by the time they have completed their leveraged buyout. That buyout, incidentally, was provoked by a raid from the Haft family. Why are these workers being terminated? Is Safeway closing otherwise productive stores? If they are productive, why are they being closed?

Mr. WYNN. To pay off the debt. We estimate the total closures and loss of jobs will be probably 33,000, some of which we might be able to save because of pressure that we could put on the employer that might secure it. But the reason for the closures is very simple. It's because here you had a company, a profitable company, not the most profitable in our industry but a company that made a $300 million profit last year, but when the indebtedness was created by the so-called friendly takeover to fend off the Haft family, they created an indebtedness of $4.6 billion.

The only way that they could pay off that debt, which is the court case that we're trying to bring against them—the only way that they could pay off that debt is to sell off part of their operation.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you. I see we're about to have a vote, so I will be somewhat brief.

Bill, you talked about supermarkets generally and Safeway in your opening statement. I have a list of some basically nonretailer but nonetheless food related acquisitions which I'd like to read briefly to you and then have you tell me two things.

First, were the workers seriously affected as a result of any of the acquisitions I'm going to read? And second, would the changes in the law which a number of you have testified to make any difference as to whether or not these acquisitions or mergers went ahead?

Ralston-Purina's acquisition of Continental Baking in 1984—its effect on workers?

Mr. WYNN. That's not in my jurisdiction.

Senator HEINZ. It's not?

Mr. WYNN. It's the baker and confectionary workers.

Senator HEINZ. And they're not here.

Mr. WYNN. They're not here.

Senator HEINZ. Beatrice acquisition of Asmark?

Mr. WYNN. I can't——

Senator HEINZ. Phillip Morris of General Food?

Mr. WYNN. That's bakery and confectionary workers.

Senator HEINZ. Nestle's acquisition of Carnation?

Mr. WYNN. I think that's bakery and confectionary. We should have had John come.

Senator HEINZ. All right. Pepsi Cola of Kentucky Fried Chicken? I hope that's not bakery workers.

Mr. WYNN. It's not us.

Senator HEINZ. It's not you. Well, so much for that line of questioning. I thought I might learn something.

Let me ask the latter question then, which is this. To what extent, Bill, would the various mergers and hostile takeover measures that you've cited in your testimony have actually have been prevented by what you've all testified that you want us to do? How would those restraints really have worked? Would they have worked?

OUTLAW GREENMAIL WITH S. 227

Mr. WYNN. Well, take Safeway as an example. I don't think you could say that it would have been prevented, but several factors—you know, we deal with the question in my statement and in secretary-treasurer Donahue's statement and even in Senator D'Amato's proposal, S. 227, of greenmail. As an example, there would be no greenmail to the Haft family of $140 million for losing and what it would have done I think—at least I would assume that if we would come up with a law that makes a certain amount of sense——

Senator HEINZ. I think we're all against greenmail and we would like to outlaw it. But even if we did, is that going to stop what's going on?

Mr. WYNN. No. That's just one aspect of it. As an example, if you take the Safeway situtation, the Haft family wouldn't have been able to force Safeway as a corporation to run out and KKR.

Senator HEINZ. So could it have prevented it?

Mr. WYNN. Absolutely, it could prevent it.

Senator HEINZ. No guarantee, but——

Mr. WYNN. No guarantee.

Senator HEINZ. Jack, what do you think?

Mr. SHEINKMAN. I think you can use the same analogy on plant closing legislation, if I may. Notification gives you an opportunity to get involved, which is I think what Bill Wynn was saying, and I think what Jim Hatfield and Mike Stone were saying is that if we have an opportunity to get involved—a lot of these situations we don't know what's happening. For example, in an attempted takeover before a white knight, Westpoint Pepperil bought Pluitt. I called the chairman of the board of the corporation and he said, "Well, under the SEC rules, I can't discuss it with you. I can't tell you what's happening." You're under a limitation and we represent some 6,000 workers in these facilities and since the takeover—a friendly takeover—we've lost about 2,000 jobs. Plants have closed.

DEBT MUST BE PAID

Because what happens is the debt has got to be paid off somewhere down the line and the only way you pay it off is on the backs of the people who work for you. You close a plant that has nothing to do with efficiency or what's considered a good profit margin and that's where I think we have an opportunity, Senator Heinz, is with the notification we can obviously do something and where we are strongly organized we can bring pressure to bear. But if we don't know what's happening, we're really operating in the dark and in most cases workers are operating in the dark.

And you can take legal action, which we are contemplating now involving Reeves Brothers. Without that, you wouldn't get that opportunity.

Senator HEINZ. Let me ask Jim Hatfield this last question. I have to apologize. I'm going to have to go vote and I suspect some of my colleagues will have to, too.

Jack Sheinkman has just made an eloquent plea for an impact statement as a means of making sure that people are better informed. Would such an impact statement or the prohibiting of greenmail or the prohibiting of golden parachutes or any of those kind of things have stopped the two cases that you spoke about—Owens-Illinois and Owens-Corning—from having taken place?

Mr. HATFIELD. No, it would not, Senator, in these two particular cases.

Senator HEINZ. Wouldn't they have helped in some way?

Mr. HATFIELD. Well, I think if you look at our recommendations that we suggest—and there are others, of course, from the committee and secretary-treasurer Donahue—if you adopt just a few of them and tighten the reins just a little bit—maybe we didn't get our message across—I know that you're a learned person on this subject since you've been involved in steel so long, but somehow we have to get the message to the people that only want to buy a company for a short period of time, say 2 or 3 years, and then put it back on the market, and reinvest—and that's where the two glass companies that we have practically lost have suffered—if they don't reinvest and only buy and then sell off a third of the company to pay off the bank at the end of the month, that's what's destroying this industrial base that we're talking about. And all the suggestions that we're trying to come up with individually—we didn't even communicate prior to coming here—we are throwing our ideas to you to help us stop this thing—this cancer that I call it, of destroying a company.

Now we have others that have been successful. The American Can Co. and the Foster Forbes Co. are putting money into that company. Nothing has changed. But then the other type of people that sit up in New York or wherever, they have no interest in that company. They have no interest in our people and we've been there for many, many years and they're thrown out on the street.

Somehow we have to get, as I indicated earlier, faith back into the system of or free enterprise system.

Senator HEINZ. Jim, thank you very much. My time has expired and I've got to go and vote. Thank you.

Senator GRAHAM. Thank you, Senator Heinz.

Senator Chafee, we are going to be having a vote in about 8½ minutes. If you could take a few seconds for your questioning and then the chairman has asked if I would recess until we vote and we will reconvene at the conclusion of this voting cycle.

Senator CHAFEE. OK. My questioning is going to be short.

First of all, I want to say I think the testimony each of you have given is terrific. You've pointed out some real problems. I'm familiar with this because Gillette went through this business of trying to fight off a takeover attempt and I think Jack Sheinkman's illustration on page 6 of Oureen Jones—worked there 27 years and gets $126 a month pension—compare that with Mr. Wyman at CBS. You saw that yesterday. He got off pretty well, didn't he? He worked there about 4 years and came away with $400,000 a year for the rest of his life and now they say they've got to save expenses at CBS so they're cutting everybody back. Boy, what an illustration of American industry in action.

And I think the question is what to do? We recognize the problem. I share your indignation. In 1984 I did something in the tax bill to try to handle the golden parachutes. Apparently it hasn't worked out. Mr. Wyman is floating down there pretty nicely with no trouble.

But we're going to look over your suggestions, particularly regarding the greenmail. Gillette paid greenmail. I think the quote you have from what happened to Goodyear, Mr. Stone, and how sad it is Mr. Mercer's statement, that with what they're paying annually in interest—$200 million a year to fight that takeover—they could have built a new plant instead of closing one.

So I share all your concerns and will look over what you've suggested. If you've got any other ideas—our problem here is we're not exactly sure what to do or how to do it. I think we can get greenmail and I hoped we had gotten golden parachutes but I guess we haven't, but obviously in some cases a person is entitled to go out and buy a company and where to draw the distinction is the problem we're facing and we look to you for all the help we can get.

I think they're wrecking the American economic system and the manufacturing system. So with that, a strong letter will follow. [Laughter.]

Thank you very much.

Senator GRAHAM. Thank you, Senator Chafee.

We're going to recess. If I might say, I asked a question of Mr. Donahue relative to any particular issues raised, whether either the company to be acquired had substantial employee ownership such as Eastern Airlines did, or where the acquiring group has substantial employee ownership as in the United Airlines case, without having time to ask would it apply, I might ask if you would consider any special implications that would relate to those circumstances and maybe supplement your comments with any thoughts that you might have as to whether and if so how those circumstances should be taken into account in our consideration of this issue of corporate takeovers.

Thank you very much. We will recess until the chairman returns.

[Recess.]

The CHAIRMAN. The committee will come to order.

Our final panel is Jack Bavis, president, Master Executive Council, Eastern Airlines; Charles Bryan, president, district lodge 100, International Association of Machinists and Aerospace Workers; Delbert Walsh, president, Local 252, Glass, Pottery, Plastics & Allied Workers International Union; Clayton Oster, president, Local 26, United Rubber, Cork, Linoleum & Plastics Workers of America; and Mary Jane Barry, president, Local 553, Transport Workers Union.

We're delighted to have you folks here. Mr. Bavis, go right ahead, sir.

STATEMENT OF JACK BAVIS, PRESIDENT, MASTER EXECUTIVE COUNCIL, EASTERN AIRLINES

Mr. BAVIS. Thank you, Mr. Chairman.

We've put into the record some very extensive depositions and court manifests and manuscripts and also some videotape which I would recommend to you for your listening pleasure when you have a chance to do that.

I am Capt. Jack Bavis. I am presently serving as the MEC chairman of the Eastern Pilots, representing some 4,400 pilots of ALPA.

As I said, I have submitted extensive things for the record. The material contains an amended verified complaint concerning a lawsuit which ALPA, the IAM and TWU, as a labor coalition, brought against Texas Air Corp. and Eastern Air Lines principal officers and its board of directors protesting the manner in which the airlines was sold.

QUESTIONABLE BUSINESS ACTIVITIES

In this documentation you will find an almost unbelievable litany of alleged questionable business activities—stock manipulations, secret presale agreements made between the chief operating officers of the two companies without the knowledge of the Eastern board of directors, secret disclosure of nonpublic information concerning Eastern's projected financial picture, nondisclosure of essential information, misleading proxy materials, and suspected insider trading practices, to name just a few.

At the time of the sale, Eastern's employees, represented by the three labor groups here before you today and the noncontract employees, constituted the largest single stockholder block, owning 25 percent of the common stock of the airline. This ownership position was attained in a blend of wage givebacks, wage investment, and wage deferral plans which had been offered by the company during the previous decade as a means of keeping Eastern salaries somewhat competitive with the rest of the airline industry. The stock cost the employees over the years some $900 million or $28 a share, and was paid for in "sweat equity."

On more than one occasion during the months prior to the company's sale, representatives of this shareholder group requested of the board of directors the opportunity to purchase our troubled airline. We were always told that the airline, was not for sale. Then, virtually overnight, our airline through a prearranged deal, was offered to a corporate raider at a "bargain basement" price, with built-in protections and compensation afforded the members of the board of directors who effected the sale, despite additional concessions given or promised by the union.

Much has been said and written in the past few years concerning the financial ramifications of such leveraged buyouts and unfriendly acquisitions. We have become familiar with the wild stock swings that take place in Wall Street at the mere mention of a "takeover target." Indeed, I am sure that many of those who preceded me before this committee and many who will follow will adequately address the issue of greenmail, poison pills, shark repellant, junk bond financing, golden parachutes, and the like—and I thought I lived in a technical world. Far less has been written and said about the human carnage that such buyouts almost always leave in their wake.

MANAGEMENT AIDED CORPORATE RAIDER

In our particular instance, Eastern paid 51 percent of its own acquisition cost. Our previous management aided and abetted a debt-heavy corporate raider acquire our significant tangible assets for less than their real worth and for very little cash required of the purchaser. The net effect of this action was to set up our company as a "cash cow" since the buyer had very little of his own equity in the transaction and therefore had no compelling reason to do all in his power to safeguard the survival of Eastern.

Since the takeover, the new management has behaved as predicted by spinning off some of our most profitable assets to a private holding company, systematically transferring our aircraft and routes to other carriers in the same corporate family, refusing to recognize key elements of legally binding work agreements, and otherwise intimidating employees into accepting the corporation's bottom line mentality to the detriment of air safety standards common to this industry.

Eastern's pilots are already the lowest paid of the seven largest carriers in America, having agreed to a $480 million salary give-back under the terms of our latest contract—a concession which the previous management had told us was necessary to prevent the sale of our company. Within months of acquiring Eastern, the new management has demanded an additional $114 million salary cut just for pilots.

My once-proud airline is losing one pilot a day to resignation or early retirement. Stress is a daily visitor in our cockpits. Pilots have been transferred from one base to another with whim and caprice. Our working conditions deteriorate daily as the company is squeezed for every last drop of capital.

Mr. Chairman, I imagine that it is too late to turn back the clock and save my airline, which proudly served the traveling public for more than half of a century, from being quickly milked to death.

For the sake of the 45,000 employees at Eastern and their families, I would urge you to call upon the SEC to investigate the particulars of this specific buyout to set the stage for criminal and civil lawsuits of guilty parties, if justified.

Finally, I would hope that upon reading the materials entered into the record you would propose legislation to prevent what happened to Eastern from ever happening in America again.

As a comment to some of the questions and anticipation of them, Mr. Chairman, in the question of poison pill, I don't believe poison pill language to prevent corporate takeovers should ever apply to employee groups to prevent them from trying to purchase their own company.

And in terms of what is going on in this world for us today, deregulation, which the Senate and the Congress of the United States passed some years ago, which I believe is going to unwind . . . it never was contemplated that we would end up with fewer competitors in the marketplace. What is happening is that the airline industry is going to end up with 5 or 6 megacarriers who are going to control this whole industry without regard to the employees, the traveling public, and I submit to you, with a lot less competition than there was before.

Thank you, Mr. Chairman.

[The complete prepared statement of John J. Bavis, Jr. follows:]

among the unemployed. Dr. M. Harvey Brenner of Johns Hopkins University prepared a study in 1984 for the use of the Joint Economic Committee of the U. S. Congress titled "Estimating the Effects of Economic Change on National Health and Social Well-Being." Among the many statistics generated from Dr. Brenner's investigation is one which shows that among those who are forced into unemployment through the closing of a plant, the suicide rate is thirty times higher than that of the rest of the population.

In a takeover battle then, workers, customers and the community, factors generally recognized as of little concern to the takeover artist, are ultimately the losers. Workers often finance the costs of a raid by job losses or pay cuts. Even workers who may keep their jobs for now pay the price of job insecurity as they run the very real risk of losing those jobs later on as the company finds itself becoming less competitive in the future.

While the Goodyear attempt is the most clear-cut in terms of the effect on its employees, other companies in the rubber industry have also had experience with corporate raiders. Firestone, BFGoodrich and Uniroyal were all involved with Carl Icahn at some point over the last several years. Goodrich paid greenmail to Carl Icahn. Uniroyal did the same, then entered into a leveraged buyout situation before selling its operating companies to pay off debt incurred in the LBO and finally liquidated the Company. So far, our people still have their jobs, but they certainly didn't get rich as a by-product of the entire transaction. Icahn and those involved with the LBO made millions. In all these cases, millions of dollars were diverted to nonproductive, noncompetitive uses.

More recently, GenCorp, known as General Tire & Rubber Company until 1984, found itself the target of a takeover attempt by a partnership affiliated with AFG Industries Inc. and Wagner & Brown. AFG Industries is an Irvine, California based glass maker while Wagner & Brown is a privately held oil and gas concern headquartered in Midland, Texas which has had ties with T. Boone Pickens. The partnership has made clear its intent to sell GenCorp's aerospace and soft drink bottling businesses to repay debt incurred in the takeover. It is unrealistic to expect the rest of GenCorp's businesses to be unaffected.

Whether this attempt succeeds or not, GenCorp, like Goodyear, will probably be a different company in the near future. It will either be radically restructured or dismembered depending on which side wins the contest. Jobs will be lost, communities will be affected either way.

There is something inherently wrong with our system when it allows and even encourages this kind of corporate extortion. This kind of power must be curbed. A business should be able to operate to benefit its customers, its owners, its employees and its community—not the corporate raider who generally knows little or nothing about the company he is raiding or the industry in which that company operates, who does not care what hardship his tactics may bring to the people who work for the target company and to the community at large and who is motivated by only one thing—money.

We are asking the Congress for help in "restructuring" our laws so they do not allow the dangerous speculative excesses that fuel the takeover epidemic.

We see the following as steps that can afford protection to workers involved:

1. Greenmail should be prohibited.

2. Our securities laws should be examined with an eye toward stopping hostile takeovers.

3. Laws regulating banks and investment companies should prohibit involvement in a hostile corporate raid.

4. Mechanisms need to be developed to protect the interests of workers and communities affected by takeovers such as requiring anyone who gains control through stock manipulation to operate the corporation in its form at the time of its takeover for three years.

The activities of the corporate raider represent a serious threat to our Nation's future economic competitiveness. I cannot stress that strongly enough. I am very concerned that our ability to remain a major world economic power is being compromised and damaged beyond repair.

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STATEMENT OF
CAPTAIN JOHN J. BAVIS, JR.
CHAIRMAN, EAL MASTER EXECUTIVE COUNCIL
AIR LINE PILOTS ASSOCIATION
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE
APRIL 8, 1987
CORPORATE TAKEOVERS

Mr. Chairman, and members of the Committee, thank you for allowing me to appear before you today and present, for your consideration, another case history involving highly suspect business practices in the buyout of one company by another.

My name is John J. Bavis, Jr. I am an Eastern Air Lines Captain and the current chairman of the Master Executive Council of the Air Line Pilots Association at Eastern, representing 4,400 Eastern pilots.

I have brought with me today, and I submit for the record, extended documentation concerning the buyout of Eastern Air Lines by Texas Air Corporation. The material contains an amended verified complaint concerning the lawsuit which ALPA, the IAM and TWU, as a labor coalition, brought against Texas Air Corporation and Eastern Air Lines Principal Officers and it's Board of Directors protesting the manner in which the airline was sold.

In this documentation you will find an almost unbelievable litany of alleged questionable business activities -- stock manipulations; secret pre-sale agreements made between the chief operating officers of the two companies without the knowledge of the Eastern Board of Directors; secret disclosure of non-public information concerning Eastern's projected financial picture; non-disclosure of essential information; misleading proxy materials; and suspected insider trading practices, to name just a few.

At the time of the sale, Eastern's employees, represented by the three labor groups before you today and non-contract employees, constituted the largest single shareholder block, owning 25% of the common stock. This ownership position was attained in a blend of wage givebacks, wage investment and wage deferral plans which had been offered by the company during the previous decade as a means of keeping Eastern salaries somewhat competitive with the rest of the airline industry. The stock cost the employees over the years some $400 million dollars, or $28 a share, and was paid for in "sweat equity".

On more than one occasion during the months prior to the company's sale, representatives of this shareholder group requested of the Board of Directors the opportunity to purchase our troubled airline. We were always

The CHAIRMAN. Thank you, Mr. Bavis. Mr. Bryan.

STATEMENT OF CHARLES BRYAN, PRESIDENT, DISTRICT LODGE 100, INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS

Mr. BRYAN. Thank you, Mr. Chairman. I appreciate very much the opportunity to appear here and to share our experience with the committee. I think it is a very important exercise for us.

My name is Charles Bryan. I am the president and general chairman of district 100, the International Association of Machinists and Aerospace Workers.

We represent 16,000 employees in the air transportation industry and 13,000 who are employed by Eastern Air Lines. They are in various capacities and a wide range of jobs, and our union represents 801,451 members in about every industry in the country.

DISENFRANCHISED SHAREHOLDER

I was hired by Eastern as a mechanic nearly 31 years ago and have been on a leave of absence for 15 years to serve as a full-time union representative. From April 1984 through November 1986, almost 2½ years, I was a member of Eastern's board of directors and served on the board's finance committee. I am also a disenfranchised shareholder in Eastern Air Lines, having personally owned nearly 5,000 shares of Eastern common stock prior to being forced to sell in the aftermath of the Texas takeover.

While my testimony today will exclusively focus on the details of the Texas Air takeover of Eastern Air Lines, I believe my comments will be relevant to the imperiled rights of all investors in public-held companies in America.

I am here as a representative of 13,000 owners of a major U.S. corporation, who just happen to be employees, to represent their ownership rights in their company.

As a 31-year employee of Eastern Air Lines, I am also here to represent the interests and hopes of all 40,000 Eastern employees who collectively owned, at the beginning of 1986, an estimated 30 to 35 percent of Eastern Air Lines common, the single largest block of stock in the company.

As a former member of the board of directors, I am also here in a continuing effort to fulfill my fiduciary responsibility to represent the rights of all the former stockholders of Eastern Air Lines.

I am here because they have been all disenfranchised of their ownership rights and because the events by which they were disenfranchised and which I document in my written testimony, have broad and serious implications for public policy in the securities industry and the rights of stockholders in all U.S. corporations.

Finally, I am here because what happened at Eastern can jeopardize one of the principles of our country, which distinguishes us from most other countries in the world: that every working American has the right to be a partner and an owner in the American dream.

Congress has clearly indicated its intent in past legislation to further the rights of all employees to own a stake in corporate America. At Eastern Air Lines, a single event which took place on the night of February 24, 1986, violated all the values and principles embodied in that legislation.

From December 1983 until that night of February 24, 1986, the employees, managers, and stockholders of Eastern Air Lines were engaged in a unique exercise which defied all odds and many doomsayers.

We were told that it was impossible for employees and management to work together, in harmony, to turn around a sick and financially strapped company. Yet in 1984, and in the first part of 1985, the employees and managers of Eastern set an example of what can be done if everybody works together, as was chronicled by many independent observers in both the popular press and in academic publications.

We were told that there was no way Eastern could return to profitability without slashing wages, benefits and working conditions to the level of bankrupt Continental Airlines. Yet in the first 7 months of the year preceding the sale, Eastern showed an operating profit of nearly $300 million and a net profit of $168 million, the greatest level of profitability in the company's entire half century history.

We were told that the unions were not concerned with profitability of Eastern, yet our unions proposed to management in 1985 an innovative fail-safe wage structure which would directly tie labor costs to corporate performance. If performance went up, the employees would receive their proportional share of the benefits. If performance fell, the employees would bear their share of the sacrifice.

More recently, we were told that the employees were not really interested in making the necessary commitment to become 100 percent owners of their company and to turn the company around. Yet in November 1986, all the employee representatives unanimously agreed to cut labor costs by $500 million in order to accomplish both of these goals.

We have been told that the employees can't raise necessary financial resources to buy their company. Yet we have a written commitment from a prominent New York investment bank that they are ready, willing and able to secure sufficient funds to carry out this transaction on behalf of the employees.

Finally, some would have you believe that we would never find capable management, management who would be willing to work with the owner/employees and their union representatives to turn Eastern to profitability and a high standard of service. Yet we now have an employee coalition headed by Mr. Sam Higginbottom, former president of Eastern Air Lines, former president of Rolls Royce of America and former director of Rolls Royce in England. Unquestionably a highly respected and competent executive in the aerospace and airline industry.

Well, what went wrong? Why are the employees not the full owners of a rejuvenated and vibrant Eastern Air Lines.

EMPLOYEES DENIED COUNTEROFFER

One event in the early morning hours of February 24, 1986 stood in their way. On that night, the board of directors of Eastern Air

Lines, with the exception of the four directors who represent the employee owners, with one other individual, Mr. Frank Lorenzo, chairman of the board and president of Texas Air Corp., resolved, without any approval of all other stockholders of the company, to sell Eastern to Texas Air Corp., in such a way as to definitively and irrevocably deprive any other party, including Eastern's owner employees of any opportunity to make an alternative offer.

In a frenzied environment on the night of February 23 and into the early morning hours of February 24, the board of directors of Eastern Air Lines, without regard for the interests of shareholders committed to a contract which virtually gave the assets of a company with $5 billion in annual revenue to Texas Air Corp.

The provisions of that agreement created a catch-22, in that all interested investment bankers or potential minority partners said they could not make a deal unless the Texas Air lock-up was broken. And all lawyers said no judge will break the lock-up until you produce an alternative deal.

Also numerous superior offers from the employees coalition to the board of directors were rejected by the directors without any consideration for shareholders rights and interests.

The board defended its action by alluding to its self-imposed lock-up and no shop provision of the Texas Air contract.

Before the Eastern directors entered into the agreement with Texas Air, the board manipulated the dates of Eastern's annual meeting and implemented a poison pill provision for the express purpose of thwarting any employee offer to buy the company in its entirety. It was not until the eleventh hour that we overcame what appeared to be an invincible handicap of that catch-22. We were able to secure professional assistance, made a financially viable superior bid for the company on behalf of Eastern employees——

RECOMMENDATIONS

Our recommendations are that any new stock issued as a part of the merger of acquisition should not be entitled to vote in support of the agreement. That is, in effect, what a lock-up is.

No officer, board member of board chairman should engage in discussions pursuing a merger or acquisition without the full knowledge and at least the 80-percent approval of the full board of directors.

Three, it should be mandatory that the full board of directors participate in all deliberations related to the mergers and acquisitions.

Four, the employees of the company who hold more than 20 percent of the outstanding shares through some form of stock trust of employee stock ownership plan should have the first right of purchase in the event that the board of directors is considering a sale of the company.

And finally, I would like to say that we are inspired by these hearings which demonstrate that Congress is not going to stand by and not get involved while the 40,000 employees of Eastern are bludgeoned into submission.

We believe that Congress has the power and the authority to restore Eastern Air Lines to its rightful owners and preserve a management-labor culture which could serve as a model superior to anything known in the world today.

Thank you.

[The complete prepared statement of Charles E. Bryan follows:]

told that the airline was not for sale. Then, virtually overnight, our airline through a prearranged deal, was offered to a corporate raider at a "bargain-basement" price, with built-in protections and compensation afforded the members of the Board of Directors who effected the sale, despite additional concessions given or promised by the union.

Much has been said and written in the past few years concerning the financial ramifications of such leveraged buyouts and unfriendly acquisitions. We are all familiar with the wild stock swings that take place on Wall Street at the mere mention of a "takeover target". Indeed, I am sure that many of those who preceeded me before this committee and many who will follow will adequately address the issues of "greenmail", "poison pills", "shark repellant", "junk bond financing", "golden parachutes", and the like. Far less has been written and said about the human carnage that such buyouts almost always leave in their wake.

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Mr. Chairman, I imagine that it is too late to turn back the clock and save my airline, which proudly served the traveling public for more than half of a century, from being quickly milked to death.

But, for the sake of the 45,000 employees at Eastern and their families, I would urge you to call upon the S.E.C. to investigate the particulars of this specific buyout to set the stage for criminal and civil lawsuits of guilty parties, if justified.

Finally, I would hope that upon reading the materials entered into the record you would propose legislation to prevent what happened to Eastern from ever happening in America again.

Thank you for your interest and attention, and I will be happy to answer any questions you may have.

Written Statement of Charles E. Bryan
On Behalf of District 100, International
Association of Machinists and Aerospace Workers
Before the Committee on Banking, Housing and Urban Affairs
United States Senate

April 8, 1987

Mr. Chairman and Members of the Committee:

My name is Charles E. Bryan, and I am President and General Chairman of District 100, International Association of Machinists and Aerospace Workers (IAMAW). District 100 represents 16,000 employees in the air transport industry, 13,000 of whom are employed by Eastern Air Lines in a wide range of capacities. I was hired by Eastern as a mechanic nearly 31 years ago, and have been on a leave of absence serving as a full-time union representative for the past fifteen years. From April 1984 through November 1986, I was a member of Eastern's Board of Directors and served on the Board's Finance Committee.

As I understand it, the purpose of today's hearing is to investigate takeovers of various types and their resulting effects on employees, shareholders and communities. In order to properly analyze the Texas Air acquisition of Eastern Air Lines, I must briefly review the events of the past decade which led to this sale.

1. EASTERN AIR LINES: 1976 TO 1986

The employees at Eastern Air Lines are no strangers to corporate crises, hard times and wage reductions. It was at Eastern, in 1976, where the first employee concession in the airline industry was pioneered, shortly after Frank Borman became Chairman, President and Chief Executive Officer of the company. During the decade preceding the sale of Eastern Air Lines to Texas Air Corporation, Eastern employees sacrificed - in truth, they invested - more than $900 million in reduced wages and benefits.

In September 1983 the employees of Eastern were once again confronted with demands for huge wage and benefit cuts. The alternative, they were told, would be at best Chapter 11 reorganization and at worst Chapter 7 liquidation. I would note that Eastern's initial overture to the three major unions at the company came six days before Continental Airlines declared bankruptcy and abrogated its labor agreements. Over the next three months, the Eastern unions negotiated round-the-clock with management to reach a solution to the company's problems that would be both equitable and effective.

The result of these negotiations was the much-heralded "Wage Investment Program" (WIP) which marked a turning point in labor/management relations at Eastern. The key elements of the WIP were:

a) During 1984, employees invested almost $300 million in the company and became, as a group, the single largest shareholder. They purchased 12 million common shares, or 25% of all the voting stock, and had four representatives on the Board of Directors. In addition the employees became the exclusive owners of 3 million shares of a new issue of preferred stock with rights to 20% of all future profits and preferential liquidation rights of $260 million.

b) Labor and management worked cooperatively to implement major efficiency and other non-labor cost saving programs. Employees shared in insider information, reviewed all major expenditure programs, made monthly reviews of the company's performance, and participated in the actual design of Eastern's business plan. The IAM alone, in addition to its wage reductions, provided at least $137 million in ongoing cost savings from January 1984 to January 1987. Another feature of the WIP was that four employee representatives were named to Eastern's Board of Directors.

Through the 1984 WIP and labor/management cooperation, Eastern cut its losses from $184 million in 1983 to $38 million in 1984 and, in the seven month period from February 1 through September 1, 1985 produced $168 million in profits, which was by far the most profitable period in the history of the company.

The new corporate culture of labor/management cooperation at Eastern was extensively researched, analyzed and praised by academics, journalists, labor specialists and management consultants. Articles on the Eastern model appeared in the Harvard Business Review, the Washington Monthly, the New Republic, Business Week, the Wall Street Journal and scores of other publications. It was also the subject of seminars, symposia and conferences at leading universities, including the Kennedy Center at Harvard, the University of Michigan, Indiana University, the University of Oregon and the U.S. Department of Labor. Even the Chairwoman of West Germany's Co-Determination Foundation marveled at our achievements.

We consistently experienced periods of astounding financial and operational improvements when management sincerely embraced the cooperative labor/management effort. However, it appeared that top management perceived that it was "losing control" or sacrificing traditional authority. Management coped with its insecurity by resorting to its traditional unilateral practices. As a result, the employees felt betrayed and their faith in the "New Eastern" was severely undermined. Unfortunately it is now our firm belief that while these exemplary relationships were being developed, Eastern's incumbent management had decided to embark on a course of action to regain autocratic control of the company, even if it meant destroying all of the benefits of cooperation or selling the company in its entirety to another entity. We are further convinced that top management was privately aided in this plan by some members of the Board of Directors.

While volumes could, and probably will, be written about the "Eastern Experiment", the purpose of these hearings is to explore the Texas Air takeover of Eastern and its consequences. Therefore I will not further burden the Committee with the details of this history.

II PRELUDE TO THE SALE OF EASTERN

In the first seven consecutive months of the one-year period preceding the sale of Eastern Air Lines, the company showed remarkable financial resuts, with operating income of almost $300 million, far exceeding any prior performance by the company. Unfortunately this prosperous period came to an abrupt end as Eastern's managament implemented a plan that led to the demise of Eastern as an independent company, delivering it into the waiting arms of a corporate raider.

Only five months preceding the sale, management, without any explanation, implemented a new operating plan which severely cut back Eastern's utilization of its assets. They reduced their planned block hours of flying by 5 percent and canceled another 3 percent, which translated into an annualized reduction in revenue of $400 million. This was only one of many negative actions which led to the immediate hemorrhaging of the profits produced through the preceding seven months.

Before these negative management decisions were disclosed either to the Board of Directors or the unions, the IAM, in an effort to give Eastern an additional competitive edge in the industry, proposed an agreement to reduce the top rates of pay in our contract by 5 percent. The IAm members ratified this 5 percent pay reduction on October 17.

Once management's plans were disclosed, I made a written report at the October 22, 1985 meeting of the Board of Directors. In that report, entitled "Fulfilling our Fiduciary Obligations," I stated:

> "From this initial salvo, it is clear that management is preparing for another round of gloom and doom. Without question, a 1986 Business Plan will be shortly forthcoming to detail and bolster the projections for massive losses in 1986. Obviously, this latest contrivance is geared to set the stage to create the maximum atmosphere of crisis and urgency, which will probably lead to the proposed solution being a merger. I would not be at all surprised to see a fictitious takeover from Frank Lorenzo emerge as a club to intimidate the workforce, with an ultimatum calling for further employee sacrifices."

In the closing two paragraphs of that report I stated:

> "As a member of the Financial Committee, I believe that the Board of Directors has a fiduciary obligation to determine how this impending disaster occurred - especially the conscious planning of a significant under-fly during the 4th quarter and all of 1986. I also believe the Board should thoroughly explore the failure of the projection and planning process at Eastern. From what the IAM has been able to learn, it appears that there was a very serious breakdown in communications and coordination within EAL. While the Board never saw a Forecast 1*, and has only been presented with Forecast 2* today, we understand that departments within the Company were producing "informal" forecasts which were in substantial variance to the information the Board was being provided with. It seems that there were actually different information projections, depending on the department involved, and that the estimates were not evaluated in a comprehensive manner. They were most certainly not reported to this Board. We must take steps to insure that this kind of "surprise" never occurs again.

> In conclusion, the Board should mandate that the management of Eastern Air Lines not allow this dismal forecast to leak out to the public and institutions through lenders' meetings and other forums. The only way this can be achieved is to further mandate that Eastern management be charged with the mission to exhaust every opportunity with the full workforce to utilize our resources to see that the dismal forecast does not materialize."
>
> *"Forecast 1" and "Forecast 2" are Eastern's traditional early and mid-year predictions for the current year's results.

As predicted in my October report to the Board, in November management presented to the unions a business plan which projected a 1986 loss of $263 million due to a significant underutilization of its aircraft. My next report to the Board on November 26th warned:

> "We, as a Board, must not allow another Chapter 11 scenario to develop. The impropriety of allowing such a negative situation to arise should be self-evident. Bankruptcy scares feed off themselves, and are counter to the best interests of Eastern stockholders. This is especially true for those who purchased over 12 million new shares just this summer**, without the knowledge that, even then, some members of management were aware of highly confidential negative projections."
>
> **On July 5, 1985 Eastern issued 12.6 million new shares of common stock to the public.

As it turned out, the October 22 prediction to the Board of a Lorenzo takeover was accurate. As the management-induced crisis was unfolding, on December 4, 1985 and again on December 10, Frank Borman, as part of his efforts to find a buyer for EAL, secretly met with Frank Lorenzo, Chairman of the Board of Texas Air Corp., and initiated discussions on the possible sale of Eastern to Texas Air. Lorenzo, the Chairman of Eastern's most bitter competitor, was given insider information including year-end information, detailed projections for 1986, and other highly sensitive competitive data. Borman did not report his conversations with Lorenzo concerning the sale of Eastern to the full Board of Directors and certainly not to the four emplyee representatives on the Board.

While these secret discussions with Texas Air Corp. were in progress, Eastern management was exacerbating the growing tensions at the company by short-circuiting the usual practice of extensive mediation in airline labor negotiations. Both the pilots and flight attendants had open contracts and were negotiating new collective bargaining agreements. Over both unions' strong objections, Eastern mounted an unprecedented lobbying effort to get the National Mediation Board to release the parties into a 30 day countdown to a strike. Eastern was literally seeking as early a confrontation as possible with these two key employee groups.

Not surprisingly, in the face of yet another highly publicized Eastern "crisis," the traveling public and travel agents began booking away from Eastern, with the accompanying deep erosion in revenues. Although Eastern has never defaulted on a single payment on its loans, the company further compounded the loss of public confidence, and therefore bookings, by widely publicizing the threat of a "technical" default (non-complaince with certain provisions of its loan covenants) on March 1, 1986.

The Chairman. Thank you very much, Mr. Bryan.

STATEMENT OF MARY JANE BARRY, PRESIDENT, LOCAL 553, TRANSPORT WORKERS UNION, MIAMI SPRINGS, FL.

Ms. Barry. I am Mary Jane Barry. I am the president of local 553, which represents 7,000 flight attendants based in 6 different States in the United States.

I have submitted my written testimony for the record, and I would like to add, in addition to that, a couple of recommendations for the committee.

There used to be a requirement that in order to obtain approval of a merger or a buy-out in the airline industry that the company involved had to provide assurances that the wages and working conditions of the employees would not be materially worsened. The principal need is to revive, and I would hope the Congress would pass legislation to do so. Without such protection, we will be part of an endless cycle of concessions which will not benefit the flying public or the stability of the industry.

The second recommendation that I have, I would strongly support the requirement of a community impact study, as well as a community impact commitment as to the conditions of takeovers or approvals of takeovers.

In our case, I would hope that the impact on south Florida, for example, of the cannibalization of Eastern or wholesale termination of long-term employees with families and dependents would have been given serious considerations before the Texas Air-Eastern transaction had been approved.

I would like to request that I be allowed to submit the impact study which was conducted recently by Florida University on the south Florida area.

The Chairman. Very good. Without objection, so ordered.

Ms. Barry. Thank you.

This completes my testimony, Mr. Proxmire, and I thank you for the opportunity to address the committee.

[The complete prepared statement of Mary Jane Barry follows:]

Sensing management's intent to cripple EAL's financial performance and provoke a labor relations crisis, Eastern's unions announced a plan recommending to all employees that they could each contribute to preserving their job security and standard of living by individually purchasing as much Eastern common stock as they deemed possible, directly or through their IRAs and 401(K)s.

This effort was really beginning to gather steam when management and the Board of Directors executed a series of maneuvers which were designed to thwart the employees' ability to increase their ownership leverage.

The historic date for Eastern's annual stockholders meeting is the fourth Tuesday in April. However, on January 14, 1986, the Board of Directors voted to delay the meeting until June 24, 1986 to provide sufficient time for the auditors to give Eastern an unqualified opinion on its 1985 financial statements. After this action, Eastern employees felt they had ample time to accumulate large additional amounts of company stock.

However, following that January 14 decision, management and the Board of Directors became alarmed that the groundswell of open market stock purchases by individual Eastern employees had increased the employees' ownership well above the 25% purchased in the 1984 Wage Investment Program. We conservatively estimate that employee ownership of Eastern stock reached at least 30% if not 35% of the company's outstanding shares. At their January 30 and 31 meetings, Eastern's Board of Directors was told that more than 20% of all outstanding shares had changed hands during these four weeks of January.

The Board reacted by quickly reversing its scheduling of the annual shareholders meeting. On January 31, the Board took its first step towards aborting any employee role in deciding Eastern's future by advancing the date of the annual meeting from June 24 to April 11, which was even earlier than the normal date. This second rescheduling had the effect of accelerating the "record date" - or deadline - for purchase of stock that would have a right to vote at that meeting. The new record date became February 12, the earliest permissible date under New York Stock Exchange rules, and cut short the time available to employees to make additional purchases of stock.

At that same meeting, the Board also approved a "poison pill" share purchase rights plan which in the words of Frank Borman, Eastern's Chairman and CEO, "was designed to protect the company from corporate raiders and any other person or group, including the company's unions, that acquired the requisite number of shares." At no time during this meeting or any previous meeting did Borman disclose to the full Board his prior discussions with Lorenzo concerning the sale of Eastern to Texas Air.

With reference to Borman's above-cited statement, I would note that to my knowledge none of Eastern's unions ever acquired one share of Eastern stock, nor do I believe they could legally do so. Rather, it was many of Eastern's 40,000 employees, the company's largest shareholder, who were investing additional savings to preserve their company and their jobs. The minutes of Board meetings during this time reflect certain key Directors' deep fear and disdain of expanded employee ownership of Eastern. Initially we believed that both of these January 31 Board decisions were only for the purpose of thwarting expanded employee ownership and influence. It now appears that there was an additional agenda: to protect the on-going discussions by management with Texas Air.

Parenthetically I would note that during the time that the IAM was publicly recommending that employees purchase additional Eastern stock I received a large number of unsolicited contacts from individuals in the financial industry. Many presented themselves as being interested in helping employees gain a larger share of their company. In retrospect, it seems very likely that some of these individuals may in fact have been operating in the interest of Texas Air Corp. For instance, we were separately contacted by two senior officers of Drexel Burnham Lambert (TAC's investment banker) and we received numerous calls from an employee of Ivan Boesky. These and other contacts were clearly designed to elicit the maximum possible amount of information from us. I now wonder whether or not some of this information was used by TAC and "friendly" arbitragers to design a strategy to "park" Eastern stock in various hands in anticipation of a Texas Air raid of Eastern.

On February 14, the Executive Committee of the Board of Directors, still without any prior authorization by or notice to the full Board, which included the employee representatives, instructed Eastern's investment banker, Merrill Lynch, to contact Texas Air concerning its acquisition of Eastern.

I believe that this Committee would be interested in the fact that four TAC executives, including Frank Lorenzo, carried out an internal stock transaction which allowed them to personally gain millions of dollars in profits from the rapidly unfolding events in the negotiations with Eastern.

The roots of this scheme took place in January 1984 when Lorenzo, Philip Bakes (now president of EAL), Robert Snedeker and Charles Goolsbee, all directors and/or officers of Texas Air Corp., were allowed to purchase stock in Continental's reservation system, CCS Automation Systems, Inc. These stock acquisitions were made with only a 5% downpayment in cash, the balance being held in abeyance in a loan from Texas Air itself. The actual cash outlay for each share was only 5 cents.

On February 20, 1986, just six days after their first contact with Merrill Lynch and only three days before the final consummation of the agreement to purchase Eastern, Texas Air which is controlled by Mr. Lorenzo, repurchased this CCS stock through an exchange of one share of Texas Air stock for two shares of CCS stock. At the time TAC stock was trading at $16.25. In and of itself this transaction gave Mr. Lorenzo a profit of $1.5 million on a cash investment of $5,000 (the repayment of the "loan" from TAC was never more than a paper transaction). But this profit was magnified within a week when the announcement of the Eastern sale to Texas Air drove up Texas Air's stock to close to $30. Within less than a year the favorable terms of the Eastern purchase pushed Texas Air's stock to over $50, giving Mr. Lorenzo a profit on his $5,000 investment of over $4.8 million.

I have gone into these events in some detail because the structure of this transaction and the intent to inordinately benefit a small group of individuals at the expense of public stockholders, including employees, parallels in many ways the purpose and financial method by which Texas Air acquired Eastern. I would also call to the Committee's attention the ways in which Jet Capital was used by Mr. Lorenzo and a small group of associates to control the entire Texas Air empire and to directly profit from TAC's operations.

III THE SALE OF EASTERN AIR LINES TO TEXAS AIR CORPORATION

On February 21, 80 days after the first secret meetings between Eastern and Texas Air concerning a possible merger, Eastern's full Board of Directors was finally informed of the contacts with an anonymous buyer. Over my dissenting vote and objections, the Board of Directors formally instructed management to enter into negotiations to sell the airline.

Through the weekend of February 22 and 23, Eastern management used the negotiations with Texas Air as leverage to extract new 20% pay cuts and other concessions from the pilots and flight attendants, who had open contracts. The Board had stated that if the company received the requested employee labor cost reductions, Eastern would not be sold. Although the IAM had a closed contract in force with rates that had just been reduced by 5%, we offered to consider an additional 15% pay cut. Two Board of Director committee chairmen had indicated to me that a 15% cut from the IAM would be sufficient to avoid the sale of the company. My offer to consider a 15% pay reduction was linked to the Board's willingness to appoint a new Chairman to guide the company's recovery and future growth. This was a change which would have been universally supported by Eastern's workforce at least through the middle management level. As one manager told us: "You've got to find us an Iacocca." Within minutes of being made aware of my position, Frank Borman approached me and calmly said: "I understand you want me to go." To which I replied, "It's nothing personal, Frank. It's the only way it can work." Borman then said, "I understand," and walked away.

The independence, financial stability and growth prospects of Eastern now depended on whether one individual, Frank Borman who after ten years of failed attempts to make Eastern a successful airline - even with more than $900 million in financial aid from the employees - would be willing to step aside and open the way for a new chairman who could again inspire and regain the confidence of the 40,000 employees of Eastern, the traveling public and the company's creditors.

At this point the criteria established by the Board not to sell the company had been satisfied, and according to management's own understated business plan, Eastern would have been profitable in 1986. Unfortunately, the Board of Directors elected to sell the company to Texas Air and protect their chairman.

During the long final meeting on February 23 and 24, I could not believe the Board of Directors would ever approve the sale because they had not received a fairness opinion from one of their own investment bankers, Salomon Brothers. In spite of intense pressure from Board members and others, Salomon, which had been retained to represent the outside Directors, refused to give a fairness opinion the night of the sale. Their fairness opinion was not received for several months and in fact the actual letter, as contained in Eastern's Proxy statement, is dated October 14, eight months after the merger agreement. I was not aware that during a private sessn between the outside director and Texas Air representatives, Texas Air had agreed to a two-year $35 million indemnification for the Directors, which now explains their lack of concern for the fairness opinion. To make matters worse, this entire transaction took place under pressures more commonly associated with used car lots. The Board was told that Texas Air Corp. had established a deadline (first midnight, then a couple of hours later) after which the "deal" would no longer be available. There was a frenzied and panicky atmosphere among the Board as they rose to the bait of the

IV. TERMS OF THE ACQUISITION OF EASTERN AIR LINES BY TEXAS AIR

The acquisition, as it was finally structured on the night of February 23-24 and subsequently amended on May 7, involved the payment to the common shareholders of Eastern of $6.25 per share in cash and $3.75 per share principal amount of a new cumulative junior preferred stock of Eastern. While this offer on paper was worth $10 per share, financial analysts placed its real value at $9.25, putting the presumed value of the acquisition at $575 million.

But this was not the real cost to Texas Air. Only $388 million would be paid in actual cash. The rest would be paid with a new security issued by Eastern itself. Moreover, Eastern also agreed to pay $108 million of the cash consideration, leaving only $280 million to be paid by Texas Air, or less than half of the total cost of the merger. In a Wall Street Journal article dated October 26, 1986, Frank Lorenzo is described as boasting that Eastern's Air Shuttle alone was appraised at $300 million.

Equally as outrageous, on the first day of the month Eastern was sold, the company showed a cash balance of $324 million on its books, or $44 million more in cash alone than the total cash outlay by Texas Air to buy the company. It is very difficult to explain to the employees why only two years earlier they sacrificed $296 million in wages for only 25% ownership, including the employees' holding, with only $280 million outlay.

Texas Air's undervalued bid was called a "steal" by several business publications. For a very modest outlay of cash, Texas Air acquired a company with $5 billion in revenues, substantial cash on hand and assets including such crown jewels as the Shuttle, a state-of-the-art reservation system, a modern fuel efficient fleet of nearly 300 aircraft, major hubs including Atlanta and Miami, and a route structure encompassing large portions of the United States, South America and the Caribbean. The Texas Air buyout was so disadvantageous to Eastern and its stockholders that it was bound to attract the attention of alternative bidders, with superior offers to Eastern's stockholders.

Yet at no time in the days and hours which preceded the final agreement with Texas Air did Eastern management or any member of its Board of Directors approach the employees or their union representatives about their interest in presenting an alternative bid for the airline. Given the demonstrated interest of the employees in buying additional Eastern stock, it was very evident that management had no intention to provide the employees with such an opportunity and in fact made every effort to prevent it. In fact, several prominent attorneys reviewing the details of this transaction have commented that the Board seemed to adopt a position that they would sell Eastern to anybody but the employees.

For this very reason, Easten and Texas Air agreed to a special "lockup" provision which would freeze out any alternative bid.

The first part of this lockup was achieved by selling to Texas Air 10,935,000 newly issued shares of cmon stock at an actual cash price of $1.30 per share which was described in a slide presentation to the Board of Directors which was laid out as follows:

10,935,000 @ $6.25 per share	$68,343,750
Less: $3.12 payable in a 1991 note [which was strictly an internal paper transaction]	($34,117,200)
Less: $20 million inducement fee paid by Eastern to Texas Air	($20,000,000)
Net Cash Cost for 10,935,000 shares	$14,226,500
Net Cash Cost per Share	$1.30

Notwithstanding the above, since Eastern Air Lines was destined to be totally owned by Texas Air, even the $14,226,500 payment was simply a transfer of money from one pocket of Texas Air to another.

The second part of the lockup which paralyzed any effort to make an alternate bid was an irrevocable option to purchase an additional 10 million newly issued Eastern shares at $7.50 per share. This provision, if exercised, for the same reasons explained above would have simply been putting more money from one pocket into another. This option in reality was a shield against any competitive bids while Texas Air was achieving its controlling ownership of Eastern in the open market.

In addition, Eastern's Board agreed not to entertain any higher offers for the company, no matter how potentially advantageous they might have been for Eastern shareholders.

The result of the lockup was to give Texas Air a 51% ownership of Eastern before any of the incumbent stockholders, including the employees, were given the right to vote on the mergér. It is unbelievable that the Board of Directors approved a contract which by design would not schedule a shareholders meeting to vote on the sale of the company until the buyer had more than 50% of the stock. The lockup made a mockery of the voting process and "shareholder democracy". The net effect was to disenfranchise more than two-thirds of the incumbent stock from having any say about the sale of the company.

If the techniques of this transaction are allowed to stand, then what is to prevent a future transaction which would have a lockup providing total and immediate control, disenfranchising all of the incumbent stockholders? We have calculated that, applying the same lockup formula and procedure as described above, a deal could have been structured where Texas Air would have only had to put up another $55.5 million in cash to attain an unassailable and immediate lock on majority control of Eastern stock to approve the sale with no possible ability of incumbent shareholders to vote the transaction down (in other words, the potential majority voting control could be achieved through the purchase of newly issued stock alone). Further, any funds paid for the new issue stock is irrelevant since all cash paid for such stock would obviously revert to the purchaser once it achieves full possession of the acquired company.

We believe that in view of the above, the Texas Air purchase of Eastern Air Lines should be overturned. In response to the Senate Banking Committee's request for recommendations, I submit the following:

1. Any new stock issued as part of a merger or acquisition should not be entitled to vote in support of the agreement.

2. No officer, Board member or Board chairman should engage in discussions pursuing a merger or acquisition without the full knowledge and 80% approval of the full Board of Directors.

3. It should be mandatory that the full Board of Directors participate in all deliberations related to mergers and acquisitions.

4. The employees of any company who hold more than 20% of the outstanding shares through some form of stock trust or Employee Stock Ownership Plan (ESOP) should have the first right of purchase in the event that the Board of Directors is considering a sale of the company.

Although the IAM totally opposed the sale of Eastern to Texas Air, within a few hours after the approval by the Board of Directors the IAM sent a telegram to Frank Lorenzo advocating a meeting to pursue a joint, cooperative commitment to maximize the efficiency and quality of the airline. There was never a response from Lorenzo and when asked about the telegram in a press conference he stated: "I don't talk to labor leaders."

Since the acquisition agreement, but long before the shareholders meeting, Lorenzo was making his position crystal clear with quotes in a wide range of national publications referring to the IAM as "fat cats", advocating 50% or greater reductions in pay rates and openly threatening to simply paint the tails of Eastern's airplanes to Continental colors if the unions did not capitulate.

A summary analysis of Texas Air's financial condition taken directly from the Proxy Statement and based on the pro forma combination of Continental, Eastern, People Express, Frontier and other smaller Texas Air carriers, showed that it would have total assets of $7.7 billion, total debts and redeemable preferred stock of $5.2 billion and net worth of only $591 million. Texas Air's debt load would be almost twice as large as the debt of any other carrier in the industry. A pro forma statement of Texas Air's combined operations showed total losses of $409 million for the first six months of 1986.

The magnitude of the pro forma losses and the volume of Texas Air's consolidated debt only confirmed to Eastern employees and unions that an alternative solution had to be found to the Texas Air merger. They resolved to seek an alternative buyer to become a minority partner with the employees to buy Eastern, or have a full employee purchase through an Employee Stock Ownership Plan

The lockup was the only obstacle to finding an alternative minority partner or securing financing for an employee purchase. But we were consistently told by all the lawyers that no matter how bad the Texas Air deal was, we could not win a lawsuit to bust up the Texas Air deal unless we had an alternative deal in place. The Catch-22 was that all potential minority partners or investment bankers who had expressed interest told us they could not raise the financing to put a deal together until we had won a lawsuit to bust up the Texas Air deal.

On August 26, 1986, even though Texas Air already held more than 50% of Eastern's stock, the Department of Transportation issued a final order rejecting the merger plan and ordered Texas Air to provide a divestiture plan of the Eastern holdings. On August 29, as a member of the Board of Directors, I seized that opportunity, with the approval of the leaders of the other two labor groups, the pilots and the flight attendants, to make a formal offer of $10.25 cash for each share of Eastern stock on behalf of the employees. I further requested that the Board of Directors and management cooperate with the necessary investment banking and legal assistance, consistent with what they had done when the employees made the 25% purchase of stock in 1984.

The Board refused to consider this offer and a month later a revised merger plan by Texas Air was approved by the Department of Transportation.

On October 15, during a telephone conference call Board meeting, I submitted a resolution which called on the Board to relieve the lockup situation and give the employees 60 days to make a good faith offer to buy the company. The reaction to that proposed resolution was that two days later, more than a month before the shareholders meeting, the Board elected Frank Lorenzo as the new Chairman of the Board of Eastern Air Lines, and Philip Bakes as President. The resolution was subsequently rejected.

The president of one of Wall Street's most prestigious investment banking firms, who had initially expressed great interest in participating in an employee buyout, later reflected on the Catch-22 situation created by the lockup: "Not only has the barn door been left open, but the horse has come out and run around the track and crossed the finish line."

It was not until November 10 that the Coalition of Eastern employees was successful in retaining Kelso & Co., the leading investment banking firm for employee stock ownership plans. With a nationally recognized investment banker, the Coalition was finally able to submit an official acquisition offer for Eastern Air Lines. This offer was backed by Kelso's formal expression of confidence of their ability to raise the necessary financing.

Since the Board of Directors continually refused to entertain the Coalition's superior offer, this left only 15 days to prepare a legal case against the lockup, convince a judge to stay the vote on the merger, and give the employees the opportunity to present their alternative bid to Eastern's stockholders.

The Coalition succeeded in preparing its legal case and made a much superior offer of $11.50 cash to Eastern's shareholders. The offer included many impressive features:

1. The employees would become full-owners of Eastern Air Lines, making it the largest employee-owned company in the United States.

2. The unionized employees agreed to cut labor costs by $500 million and committed by a unanimous vote to structure their future wages to guarantee that all future business plans and loan covenants of their own company would be fail-safe.

3. Kelso & Co. indicated they were ready to testify in court that they were confident they could raise the necessary funds to finance the employee buyout.

4. Mr. Sam Higgenbottom, former President of Eastern Air Lines and former President of Rolls Royce of America, crystalized the credibility of the employee offer when he resigned as a director of Rolls Royce in England in order to become the head of the employee Coalition. Should the employee buyout of Eastern be successful, Mr. Higginbottom would become the President and Chief Executive Officer of the employee-owned airline.

The only obstacle standing in the way of the employees was the fast approaching date for the Eastern stocknolder meeting at which the Texas Air proposal was already guaranteed a victory due to the lockup provision.

The Employee Coalition filed a lawsuit in Federal Court in the Southern District to stay the stockholders meeting, hold a hearing on the lockup provision and open the way to the alternative superior bid by the employees. The judge refused to stay the stockholders meeting because the Coalition was too late in making its offer, a delay caused itself by the lockup provision. The judge's order stated, however, that:

> "...if the merger is found to be unlawful after it is consummated, the merger could be judicially unwound if the law required that action.
>
> With regard to Appeal, the judge's order provided:
>
> "Due to the importance of these issues, the avenues of appeal available to the parties should be considered."

In lieu of an appeal, after a thorough analysis by a team of attorneys, including F. Lee Bailey and his associate Don Beverly, an amended complaint was filed in pursuit of opposition on December 8, 1986.

Predictably the merger was approved and consummated at the stockholders meeting on November 26, 1986.

But one important feature of the Texas Air purchase offer was turned down by the employees. Three separate votes scheduled after the shareholders' meeting failed to approve the sale of the 3 million shares of preferred stock exclusively owned by the employees. This preferred stock holds a $260 million liquidation preference and is entitled to 20% of all future profits.

The employees are seriously concerned about the financial "house of cards" created by Texas Air Corp., and about the emerging pattern of Texas Air stripping Eastern's assets and transferring them to Texas Air Corporation. They are also alarmed by the severe deterioration in the labor relations at Eastern since the takeover by Texas Air management. Some aspects of the oppressive labor relations affecting the IAM workforce are:

a. The rate of disciplinary terminations is 10 times greater than before the merger agreement.

b. Extensive disciplinary terminations and threats of termination are being experienced by the key union leadership (one of the IAM's most courteous and professional Chief Stewards was recently fired for questioning management's decision to remove numeus official IAM communications to its membership from a union bulletin board.

c. Widespread and blatant violations of the collective bargaining agreement have generated thousands of grievances and have rendered totally ineffective the normal procedures for resolving labor/management disputes.

d. Many employees are terrified by the fact that management has filed with the Internal Revenue Service a request for a waiver of more than $60 million in required 1986 payments to Eastern's pension funds, even though Eastern Air Lines could apparently afford to pay over $335 million in expenses and payments to creditors and shareholders directly related to the merger.

e. Management is eliminating many jobs and attempting to circumvent labor contracts by spinning off or restructuring into subsidiaries certain operations such as over-the-road truck drivers and security guards, and by contracting out major work functions such as engine overhaul, aircraft cleaning and various other classes of work.

f. Finally, management is openly attacking and discrediting the unions representing Eastern employees, which most recently resulted in the de-unionization of 42 IAM flight instructors.

The greatest threat to the employees was the announcement by the new Texas Air management in January 1987 that they planned to cut annual wages and benefits by $490 million. This threatened reduction is in addition to the $283 million in concessions already endured by flight attendants, pilots and non-unionized employees.

The threatened pay cuts have sent a shock wave through the South Florida community where Eastern is the largest private employer. The impact on the local economy of the management cuts were documented by a recent independent study by the Center for Labor Research & Studies at Florida International University. The study concluded that the impact would drain the economy of $436 million in the Miami area alone.

The growing hostility and tension between management and the workforce is being felt by the traveling public in the quality of Eastern's service. Continental has already established a track record for poor service under Lorenzo's management and Eastern is now quickly following Continental's example. To quote Senator Frank Lautenberg in his March 26 letter to Frank Lorenzo:

> "In expanding its air carrier network, Texas Air appears to have forgotten its passengers. Constituent complaints to our offices regarding problems encountered using Continental have increased significantly.
>
> "Texas Air decisions affecting employees of its acquired airlines have led to serious problems within the workforce. The stress that air crews, including pilots, are being put under has harmed employee morale and the level of service. There is cause for concern over the impact these problems could have on safety."

The employees have been advised by Counsel that retention of the 3 million shares of preferred stock, exclusively held by them, should serve as a bar, preventing the sale of assets or spin-off of subsidiaries since they are entitled to a $260 million liquidation preference and 20% of all future profits of Eastern Air Lines. However, management has begun to systematically dispose of key assets, such as a number of Airbus-300 aircraft, one of the most fuel efficient in the fleet, and the SODA reservation system, claimed by management to be the most sophisticated and third largest in the airline industry.

The reservation system and other Eastern computer facilities can be conservatively valued at $660 million. Yet typical of the insider-controlled transaction which has been the management style of Lorenzo's operations, a Prospectus, filed by Texas Air on February 17, 1987 with the Securities and Exchange Commission, disclosed that Texas Air proposes to transfer these valuable Eastern assets to a new Texas Air subsidiary for the mere payment of $100 million in an unsecured, uncollateralized Texas Air subordinated note.

This transaction is actually, from Lorenzo's point of view, just another instance of taking money from one pocket and putting it into another. But to the Eastern employees, it is robbing them of their entitlement under the terms of the preferred stock and will severely undermine their job security. This is clear evidence that the ultimate goal of Frank Lorenzo is to cannibalize the valuable assets of what should be an excellent airline owned by its employees, to serve as a transfusion to nourish the other sick and mismanaged airlines in the Texas Air empire.

V. CONCLUSION

Eastern is facing an imminent crisis - tense labor relations, poor employee morale, declining quality of service and the precarious financial position of the Texas Air group as a whole could lead to an explosive, uncontrollable and tragic outcome. The situation must be defused by opening the way for the employees to exercise their right to be the owners of their company and become the masters of their own distiny.

We know that Lorenzo's dismantling of Eastern Air Lines is inevitable. While we have full confidence in our position and in the federal court system, we also recognize that the complex and time-consuming judicial process of the court, with its multitude of counter-filings, motions and appeals, could delay any relief in that forum for years. This situation cries out for swift and immediate action by Congress. You may be our only real hope in preserving Eastern Air Lines as it should be.

We are inspired by these hearings which demonstrate that Congress is not going to stand by while the 40,000 employees are bludgeoned into submission and not get involved. We believe that Congress has the power and authority to restore Eastern Air Lines to its rightful owners and preserve a management/labor culture which could serve as a model far superior to anything known in the world today.

After reviewing the entire record of Texas Air's acquisition of Eastern Air Lines, we pray that this Committee will share our outrage and conclude that Congress should use its extraordinary powers to reverse this appalling transaction.

MARY JANE BARRY
President
[illegible]

Local 553
TRANSPORT WORKERS UNION
OF AMERICA, AFL-CIO
656 Minola Drive • Miami Springs, Florida 33166

EXECUTIVE BOARD
[illegible]

TESTIMONY OF
TRANSPORT WORKERS UNION OF AMERICA, AFL-CIO, LOCAL 553 BEFORE THE SENATE BANKING COMMITTEE

GOOD MORNING, MR. CHAIRMAN. MY NAME IS MARY JANE BARRY, AND I AM PRESIDENT OF TRANSPORT WORKERS UNION OF AMERICA, AFL-CIO, LOCAL 553. MY LOCAL REPRESENTS SOME 7,000 EASTERN AIRLINES FLIGHT ATTENDANTS, ALL OF WHOM HAVE BEEN DEEPLY AFFECTED BY THE RECENT PURCHASE OF EASTERN BY TEXAS AIR CORPORATION, AS WELL AS THE UPHEAVAL IN THE INDUSTRY WHICH PRECEDED THAT TRANSACTION.

AT THE OUTSET, I CONCUR IN THE ACCOUNT OF EVENTS LEADING TO THE PURCHASE OF EASTERN AIR LINES BY TEXAS AIR CORPORATION PROVIDED BY BOTH THE AIR LINE PILOTS ASSOCIATION AND THE INTERNATIONAL ASSOCIATION OF MACHINISTS. HOWEVER, FROM THE PERSPECTIVE OF WORKING FLIGHT ATTENDANTS, THE FACTS ARE QUITE SIMPLE. WE HAVE AGREED TO MAJOR CONCESSIONS IN BOTH WAGES AND WORKING CONDITIONS IN VIRTUALLY EVERY CONTRACT SINCE 1974, AND PARTICULARLY IN 1983 AND 1986. THE TRADE-OFF FOR THESE CONCESSIONS WAS QUITE SIMPLE--STOCK IN THE COMPANY AND AN UNDERSTANDING THAT HOURLY WORKERS WOULD HAVE A BONA FIDE SAY IN HOW THE COMPANY WAS RUN. WE CLEARLY NO LONGER HAVE SUCH INPUT. INDEED, MR. LORENZO HAS MADE IT QUITE CLEAR THAT HE IS NOT

INTERESTED IN OUR INPUT EXCEPT AS IT PERTAINS TO AGREEING TO YET MORE CONCESSIONS IN WAGES AND WORKING CONDITIONS. MORE SIGNIFICANTLY, WE WATCHED AS OUR COMPANY WAS SOLD AT A BARGAIN BASEMENT PRICE DIRECTLY ON THE HEELS OF THE CONCESSIONS WE MADE IN ORDER TO KEEP IT INDEPENDENT.

I AM NOT AN EXPERT IN SECURITIES LAW, AND I AM NOT PREPARED TO TESTIFY AS TO HOW THIS TRANSACTION VIOLATED THOSE LAWS. WHAT I CAN TESTIFY TO IS THAT SINCE THIS TRANSACTION HAS OCCURRED, EASTERN'S FLIGHT ATTENDANTS HAVE BEEN SUBJECTED TO MORE ABUSE AND DEGRADATION AT THE COMPANY'S HANDS THAN I CAN RECALL AT ANY TIME DURING THE COURSE OF MY CAREER. IN THE FIRST TWO MONTHS OF THIS YEAR, 46 OF OUR MEMBERS HAVE BEEN DISCHARGED. IN A NORMAL YEAR, WE DEAL WITH APPROXIMATELY 25 DISCHARGES. IN ADDITION, THERE HAVE BEEN INCREASES IN SEARCHES AND SEIZURES INCLUDING PAT DOWNS AND OTHER DEGRADING INVESTIGATIONS. FOR THE MOST PART, THESE TERMINATIONS HAVE BEEN DIRECTED AT THE MORE SENIOR AND BETTER PAID FLIGHT ATTENDANTS. THIS PATTERN CLEARLY INDICATES THAT THE AIRLINE IS ATTEMPTING TO FORCE OUT ITS OLDER AND BETTER PAID ATTENDANTS IN FAVOR OF THE NEW HIRES, WHO ARE PAID AT $817 PER MONTH.

NOW, THESE ARE FUNDAMENTALLY LABOR RELATIONS PROBLEMS, NOT QUESTIONS OF SECURITY OR ANTI-TRUST LAW. MY POINT IN BRINGING THIS UP IS THAT, IN MY JUDGMENT, THE TEXAS AIR-EASTERN

The CHAIRMAN. Thank you very much, Ms. Barry, for a fine statement. Mr. Walsh.

STATEMENT OF DELBERT WALSH, PRESIDENT, LOCAL 252, GLASS, POTTERY, PLASTICS & ALLIED WORKERS INTERNATIONAL UNION, LAUREL SPRINGS, NJ

Mr. WALSH. Mr. Chairman, my name is Del Walsh. I am president of local union 252 of Barrington, NJ, Owens-Corning Fiberglas plant.

The Barrington plant started production in 1956. October 1986, we were due to celebrate our 30th year of production. In May 1986, company officials came to the Barrington plant to outline future improvements to be made to our equipment, modernization. In October 1986, October 10, to be exact, the company called a special meeting between Toledo officials, the International Union, the local union, at 9:30 a.m. They sat us down at a table and told us our plant was going to be shut down as a result of restructuring due to an attempted hostile takeover.

CLOSING A PROFITABLE PLANT

That plant was a profitible plant, by the company's own admission. I had asked if we were shutting down because we were unprofitable. The company indicated no, that is not the reason. The company later indicated to me that we finished up the year 1986 at a 36-percent profit margin at the Barrington plant. The company also indicated, because of their $2.6 billion loan, they would have to go in and concentrate more on the core businesses, which meant that we would go out of some of the businesses and some of the production lines.

Many of the people in the Barrington plant are long-term employees. I myself, I still work at the Barrington plant. I started there in 1959 at the age of 21, shortly after getting out of the military. At that time, the company said, if you're looking for long-term employment, if you can stand the shift work, the dirt of a fiberglas plant, you will have that.

I had approximately 800 employees on the payroll as of October 10, 1986. December 26, 1986, the last of the 500 people that were furloughed received their lay-off notices. Out of the 800 people that were employed, I have 107 that were eligible for pension. They were at least 55 years of age. I had 507 that had over 10 years of service and were vested in the plan but did not have the age of 55 to participate. I had 109 of those employees who had under 10 years who were not vested at all in the plan.

The people, as they were laid off, the local union ran ads in the paper for prospective employers, trying to secure jobs for these people. The company sponsored job fairs. The State brought in the unemployment agency to explain their rights, job services to the people.

The jobs just aren't there for the people. The average wage rate in the Barrington plan was $12.56. It ranged from $14.38 for skilled labor down to $11.52 for unskilled labor. The average jobs out there for unskilled labor now are ranging at about $8 an hour and for skilled labor, it is $8 to $11.

Since the notification of the shutdown of the Barrington plant, I have had two employees die of heart attacks. One was on the job. He was an employee, who for 20 years, was performing a job of a nonlaborer's type work. He was transferred back, due to the reduction of the workforce. Approximately 10 days after this transfer into a production, a physical labor job, he had a heart attack on the job.

I have people that are just about ready to exhaust their unemployment benefits. There's people, when I had the hall open, I had these young men coming in, walking in with their children. They had exhausted their personal savings. They were getting into the savings that were intended for their children's education.

The impact not only is on the people that work in the Barrington plant but the surrounding communities. We had an annual payroll at the Barrington plant of $30 million. The majority of those employees came from a three-county area, Camden County, Gloucester County and Burlington County areas, and our purchases through vendors for the raw materials for the glass, and so forth, out of the tristate area, in New York and Pennsylvania, was over $3 million annually, and in New Jersey, excluding gas and electric, we spent over $7.5 billion annually in buying materials for that plant.

In the three small communities that the Barrington plant sits in, we paid over $550,000 a year in property taxes. I am sure once we cease the production facility there, that they will be reduced greatly, the revenue to the boroughs.

Mr. Chairman, I would just like to thank you for giving me the opportunity to explain some of the problems that the men in the factory are having and experiencing.

The CHAIRMAN. Thank you very much, Mr. Walsh. Mr. Oster?

STATEMENT OF CLAYTON C. OSTER, PRESIDENT, LOCAL 26, UNITED RUBBER, CORK, LINOLEUM AND PLASTIC WORKERS OF AMERICA, CUMBERLAND, MD

Mr. OSTER. Thank you, sir.

Mr. Chairman, my name is Clayton C. Oster, I am president of the United Rubbers, local 26. The members of local 26, are employed at the Kelly-Springfield Tire Plant in Cumberland, MD. Kelly-Springfield, with its headquarters in Cumberland, is a subsidiary of the Goodyear Tire and Rubber Co.

As said here this morning, and everyone knows, Goodyear Tire and Rubber Co. was the target of Sir James Goldsmith. The results equaled, $94 million dollars profit for him and the loss of jobs for the people I represent at Kelly Cumberland.

Sir I have submitted a brief, but would like to expand on it. We stand behind those recommendations made here this morning by Secretary Donahue 100 percent. As brother Walsh stated I would also like to point out a few facts to you instead of reading my written brief.

SMALL TOWN—BIG COMPANY

The plant in Cumberland, MD is approximately 66 years old. As the good Senator from Pennsylvania stated this morning, we in Cumberland also have the big company small town concept. Most of the income in Cumberland at this time is generated by the Kelly-Springfield Tire Co.

We always hear about concessions and especially the workers who do not want to do anything to help their cause by being competitive. The employees of Kelly-Springfield Tire Co. and local 26, URW members gave Goodyear Tire 100 percent of what they asked for in concessions in the 1984 negotiations. Unfortunately, Goldsmith came along.

TAKEOVER LEGISLATION NEEDED

There are two areas that I would like to point out concerning the takeover situation. If the takeover legislation was in place, the workers would be protected in a couple of ways. As testified here this morning, very few workers can benefit in a takeover situation. It really makes no difference to the workers if the takeover artists is able to take over the company or if the company is able to fight off the takeover, very few times do we see any benefit to the working people. This point was previously noted.

Because of the takeover situation we the workers in Cumberland are in a court case with Kelly/Goodyear. The situation of being counterproductive is very hard to address. As Mr. Walsh noted a while ago it is very difficult to address the takeover situation when the people you love and work with are all without jobs. One of my fellow employees that I knew all my life, and one of the most sound people that you would want to meet committed suicide. He was a good worker, and a devoted family man. He committed suicide, basically due to what we are discussing here today. The gentleman I am speaking of was 61 years old and could have retired no matter what the situation was because of Goldsmith.

So my point is that people care about one another, and as the gentleman's wife told me, the issue of plant closure was on his mind from the day they announced that the Cumberland plant would close, and be shut down.

The families are torn apart. I would like for someone to explain to me how these takeover artists can justify such actions. How can you explain these actions to a woman who is crying about what they are to do. The average age of the people that I represent is 46 years old. A lot of our people only have 2 or 3 years to go before they could retire, and still have children in school. They have no retirement.

So I am saying to you that there are no words to describe our situation. Our community is already depressed with plant closures. I realize that you have already listened to most of what I have said here today. The bottom line is that if we don't have some type of supportive legislation and also some commitment from the management of the companies in this country, we are all in trouble.

Without belaboring the issue and for the sake of time, I just want to say I more than appreciate on behalf of the people of Kelly Cumberland the opportunity to come down here and testify today.

I just urge the Congress to take the necessary steps, not for specific groups of people but for all America's workers and that you protect them against the consequences of a hostile takeover.

My only additional remark is that I believe that many of the American companies also use the takeover situation to go deeper into the restructuring program, and thus use the takeover as an excuse to shut down plants such as the one in Cumberland, MD.

Thank you, sir.

[The complete prepared statement of Clayton C. Oster follows:]

The CHAIRMAN. Thank you, Mr. Oster.

Ms. Barry, you say that the new management of Eastern is discharging flight attendants at a record clip.

Are they being replaced, and have you filed any charges with labor arbitrators?

Ms. BARRY. We have filed grievances on all of the terminated flight attendants, and it takes now, because the system is so clogged up, it takes approximately a year to get through the system.

NEW HIRES AT A LOWER WAGE

The CHAIRMAN. You say they are being replaced with new hires at a lower wage?

Ms. BARRY. The training school is supposed to open in May, and they would be replaced by lower pay-scale flight attendants.

The CHAIRMAN. Yes. And you feel that it is pretty clear that that is the reason they are firing the senior attendants whose pay is higher, so that they can reduce the pay; is that right?

Ms. BARRY. Yes. I believe that. The pay is only $817 for a new hire flight attendant, and the company has asked us for concessions again and our contracts are not open, and it would, in effect, automatically give them the concessions that they are looking for as far as the amount of money, if they replaced enough workers.

The CHAIRMAN. Mr. Oster, you tell a compelling story of the devastation wrought of abusive raids. Shareholders rights pale compare to the divorce, suicide visited upon Cumberland, MD, people.

Let me ask you, though, about the productivity of the Cumberland plant. If it was productive, why was it closed, and if it is productive, why won't another tire maker buy it?

Mr. OSTER. Well, first of all, to answer your other question, yes, sir, we were competitive, to answer that.

The CHAIRMAN. You were competitive. Why did they close it then? Why didn't they keep it open? If they were making money out of it, why didn't they continue?

Mr. OSTER. Maybe the hostile takeover was an excuse. I am not just sure, sir. We are in litigation. I have a court case in for breach of contract. I don't know what they had in mind, sir, we were competitive.

The CHAIRMAN. Has there been any interest on the part of other tire makers to buy it as a productive operation?

Mr. OSTER. Yes, sir, but, sir, at this point, we haven't been able to put it together, there are some notes in my brief, that explains that situation, sir. The economic people have talked to 10 different concerns. We have talked to one gentleman for quite some time in Maryland that's been interested, but so far we haven't been able to accomplish our goal. We also have the ESOP thing going, but I didn't want to get back into that again, at this time, my brief explains our efforts.

The CHAIRMAN. Mr. Bryan, you say that Eastern management implemented a counterproductive retrenchment plan 5 months before the takeover. With foresight, you predicted that the company was preparing for a merger with an antiunion figure such as Frank Lorenzo.

TRANSACTION IS NOT, IN REALITY, BEING FINANCED BY THE ASSETS OF PEOPLE WHO HAVE WILLINGLY INVESTED IN THIS SALE, BUT THROUGH FORCED CONCESSIONS FROM EMPLOYEES. THE RESULT OF THIS IS NOT AN INCREASE OR ENHANCEMENT IN EFFICIENCY OR SERVICE, BUT RATHER A TRANSFER OF ASSETS FROM EMPLOYEES WHO HAVE WORKED LONG AND HARD TO FINANCE AND SALVAGE THIS AIRLINE TO CORPORATE RAIDERS SEEKING TO MAKE QUICK PROFITS.

I WOULD ALSO SUGGEST TO THIS COMMITTEE THAT THIS SORT OF CONTINUAL INSTABILITY IN WORKING CONDITIONS AND HARASSMENT OF EMPLOYEES DOES NOT CONTRIBUTE TO THE SAFETY OF THE FLYING PUBLIC. RECENTLY, THE SENATE COMMERCE COMMITTEE MARKED UP LEGISLATION REQUIRING RANDOM DRUG-TESTING OF FLIGHT ATTENDANTS. WHILE WE DISAGREE WITH THIS APPROACH, SURELY IF IT IS IMPORTANT ENOUGH TO PUBLIC SAFETY THAT FLIGHT ATTENDANTS BE UNIMPAIRED BY DRUGS OR ALCOHOL, IT IS EQUALLY IMPORTANT THAT THERE BE A STABLE EXPERIENCED WORK FORCE OF FLIGHT ATTENDANTS WHO ARE NOT IN CONSTANT FEAR OF TERMINATION.

Statement of
Clayton C. Oster
President, United Rubber Workers Local 26
to the
Committee on Banking, Housing and Urban Affairs
United States Senate
on
Hostile Corporate Takeovers
April 8, 1987

Mr. Chairman and Members of the Committee:

My name is Clayton Oster. I am President of United Rubber Workers Local 26. The members of Local 26 are employed at the Kelly-Springfield tire plant in Cumberland, Maryland. Kelly-Springfield, with its headquarters in Cumberland, is a subsidiary of the Goodyear Tire and Rubber Company.

Goodyear Tire and Rubber Company was the target late last year of a hostile takeover attempt by the British-French financier Sir James Goldsmith. That attempt was not successful in terms of Goldsmith getting control of Goodyear, but it is doubtful that Goldsmith was terribly upset as he walked away from the whole situation with his expenses reimbursed and a $94 million profit in his pocket.

Goodyear, in response to the takeover attempt has cut research and development, reduced capital expenditures, took on $4 billion in debt as part of its stock re-purchase program, increased layoffs and closed plants.

The members of Local 26 belong, unfortunately, in that last category. Goldsmith has his money and has no concern for the hardship his scheme has caused. Goodyear got no particular pleasure from what it felt it had to do to restructure the Company and pay down an enormous debt, but it is the 1,100 members of URW Local 26 as well as the 1,400 members of URW 232 who will feel the true impact of the events of last November. These people will lose their jobs on May 21; they have kept them this long only because the collective bargaining agreement has a six-month advance notice of plant closure. These people are upset and they have every right to be.

The people in Cumberland have worked hard, they have put out a good product, they were told they were successfully competing with other Kelly-Springfield and Goodyear tire plants. Their reward was to be the unconsidered victim of a corporate raider who knew little about Goodyear except that its stocks were undervalued in relation to the true worth of the Company and who knew even less about the tire industry.

The Company initially planned to close Kelly-Springfield corporate headquarters in Cumberland as well as the production facility, a move that was expected to put 500-600 salaried employees out of a job. But local officials and the Maryland state government intervened with plans to build Kelly-Springfield a new headquarters and a tire testing laboratory saving about 500 jobs for the area. The cost to the taxpayers, which include our members, is estimated at about $15 million. The manufacturing facility was not as fortunate.

Local 26 members have done a great deal to make the Cumberland facility competitive. We made concessions in 1982 and again in 1984 and the plant was cost competitive according to management. It was the Union's understanding that Cumberland would remain in operation as long as it stayed cost competitive. When Goodyear announced the closure, the Union filed a lawsuit seeking to prevent the shutdown. We can certainly appreciate the awkward situation Goodyear faced as a consequence of the unbridled greed of one man; the Company must also appreciate the position the Union and its members now face, especially after having sacrificed to make the plant competitive. There is, quite frankly, a sense of betrayal in the minds of the Local Union membership. The outcome of the suit is still to be decided.

Regardless of the outcome, however, it will be too late for some of our members. You are well aware of the statistics that are generated by studies of plant closings, statistics that arithmetically show the various devastating effects of such an occurrence. Such studies have received a lot of attention as the Congress has examined the decline of the manufacturing sector. But, as President of a Local Union whose plant will close next month, I have come face to face, not with statistics, but with the real people whose lives are being thrown into a turmoil. I deal with it every day. A considerable number of our members need only a few months' service to get retirement benefits.

Cumberland is not a land of opportunity. It is a small town of about 20,000 residents. It has already lost PPG and Celanese and now it will lose Kelly-Springfield. The area has a true unemployment rate of 12 percent, maybe greater, in my estimation. In addition, there is underemployment as those skilled people lucky enough to find new jobs are often working in a lower-paying job that requires no skills. The area applied for $1.3 million in federal grants to assist displaced workers; $300 thousand was approved.

The people affected by a plant closure are under a great deal of pressure. That pressure surfaces in various ways, most of them undesirable. Our plant has not yet officially closed, but our people are despondent and the reality of their situation has begun to set in. Family life has suffered. So far, we've already seen three divorce cases. As one woman said to me--since the closure announcement, everything's a fight. We've also had a suicide. These are not just impersonal statistics; these are the people who made the Cumberland plant a profitable operation for Kelly-Springfield for many years; these are dedicated employees and friends who certainly deserve a better fate than the one that's been handed them.

The future for the members of Local 26 is not bright to say the least. Nor is the future of Cumberland which will have to absorb the loss of some $175 million from its economy.

This Country needs legislation to halt hostile corporate takeovers and thus prevent the kind of thing that is happening in Cumberland, Maryland today. I am not suggesting that halting such takeovers will end plant closures, but it could prevent some of them, an objective which the membership of Local 26 believes is very worthwhile. I would further urge the Congress to pass plant closure legislation which is also desperately needed.

I want to thank the Committee for giving URW Local 26 the opportunity to state our views and tell you our story. It is too late to help us, but I again urge the Congress to take the necessary steps to afford America's workers protection from the sad and costly consequences of a hostile corporate takeover.

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Mr. BRYAN. I beg your pardon, Senator. I am a little hard of hearing, and I can't hear exactly what you are saying.

The CHAIRMAN. I say you say that Eastern management implemented a counterproductive retrenchment plan 5 months before the takeover; is that right?

Mr. BRYAN. Well, actually 5 months before the takeover, they started a series of events that—we had made $168 million profit up to that 5-month period, net profit, almost 300, operational profit. They scaled the airline down and started into a whole series of events that drove the company really into the arms of the raider.

The CHAIRMAN. Well now, you suspect some sort of collusion between Lorenzo and Borman, Eastern Chairman Frank Borman.

Why have you been unable to find satisfaction in the courts or at the SEC or under current law, in your judgment?

Mr. BRYAN. We spent about a year in Washington, wandering around talking to the SEC attorneys, a lot of Congressmen, and so forth, and everyone seemed to be appalled, alarmed—even went to the White House on one occasion—about what had happened at Eastern Air Lines. But Mr. Lorenzo—it is a matter of public record—has hired the top officials from almost every agency in Washington, the SEC probably not exluded, but certainly the Department of Transportation, the CAB, and the FAA. It is a matter of record. Mr. Kahn even was on the board of directors of one his airlines, the former chairman of the CAB.

The names I don't have at my fingertips, but we know of at least about 15 at this point, former top officials in Washington agencies, and he seems to have had a real grip on getting any kind of relief in this way up here.

CATCH-22

Now in the court. We have gone into court, and we got there, because this lockup that was self-imposed by the board of directors, saying that you could put another deal in, couldn't entertain another deal, and the lawyers all said that the judge will never break that deal up, unless you've got another bid. And we went to the investment bankers, and I talked to the presidents of investment banking firms in Washington—in New York. And they said, we cannot possibly—we would like to do it for you, we would like to deal for you, but we can't do it until you get it broken in the court. So it was a catch-22. It was impossible.

It was not until just a few days before the stockholders meeting that finally Kelso gave us a letter of confidence and said, yes, they could raise the money. We did go into court, and unfortunately, the judge with just a few days left, said, it's too late. I can't take that action this close to the shareholders meeting. We have appealed that through an amended lawsuit, though, and we are still in court.

Our concern, very honestly, Senator, is that Texas Air is spinning off all the crown jewels of the airline. They have put in their statement just a couple of months ago, that they are going to sell the main crown jewel of the reservation and computer system to Texas Air Corp., it is all an internal paperwork shuffle, for $100 million in uncollateralized securities. And we know that it is worth at least $600 million to $700 million, even by comparison to other sales that have recently occurred.

The **Chairman**. Thank you. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

First, I want to thank you for hosting this hearing today and the witnesses that have come. We have had a lot of things going on today. We reported out a budget in the Budget Committee this morning where several of us serve and had to be present for that. We have had a major hearing on the trade bill, and we have had at least 2 votes on the floor since this hearing has started. So there have been some interruptions in terms of the coming and going of various ones of us.

But I find your testimony today, all of you, particularly this panel, but the others before you, to be very important testimony for us to hear and to have on the record.

There is something going on out there, when we've got plants that are productive plants earning good profits, efficient, making concessions, having doing other things to become efficient. I see this all across the State of Michigan with plants there. I don't think that what has happened is the fault of working people not giving all that they can give. There may be some exceptions to that, but I think the general pattern that I have been able to see is, that our working people are working just about as hard as they can work, up to and including even breaking their own health, in terms of trying to get the job done, so that the companies can succeed and the plants can stay open and the jobs can continue to exist.

Despite all that, it seems to me we are getting these quick arbitrary shutdowns, particularly coming off some of the hostile trading activity and the threatened takeover activity and not just individual families, but whole communities are being very severely damaged.

I think it is in the national interest for us to understand the scale of this problem, why it is happening, why we are seeing this big burst of activity, and what we can do to prevent the kind of damage that is occurring here. After all, human suffering is one measure of it, but in the end, the Government and the country as a whole, also suffers.

If people are not able to find work or are otherwise in living situations that become more and more impossible, that hurts the country, and if we are not producing the value-added production that we need and that matches our consumption in this country, we are going to find ourselves in a situation, as a nation, where we slide backward, and we are not going to be able to afford to do the things in the future that we think of our country as doing, whether it is having the big defense spending abroad or whether it is having the right kind of school system or highway system or education system or health system or what have you.

CAREFUL CONSIDERATION OF ALL SUGGESTIONS

So I think this is a matter of great urgency, and I would like you to take back to your members who are out there now, those particularly that represent workforces that have been displaced and are out there struggling, that we are going to try to do something about dealing with this problem. We are also going to have to try to do something about the cases where it is already happened, and it is too late to stop them, and where it has already taken place, and you've got people out there who have no decent prospect.

We are going to have to find a way to respond to that problem. And frankly, the President of the United States has a responsibility there and our Cabinet does and our Congress does, because it is a national problem of a scale that we ought to pay attention to. It is, in a sense, a kind of natural disaster, maybe an unnatural disaster, and we are going to have to respond to the problem of plants disappearing and closing and workers and families and communities being left high and dry.

So I am going to take all the suggestions you have made today under very careful consideration, as we go through the drafting process on legislation. And we are going to try to find steps that we can take that can prevent some of these terrible consequences from happening in our society.

I think there are some merger activities that, carried out in a proper fashion, are part of our economic system. We expect that. But I think when we are seeing a build up of circumstances such as you are describing here today, that something is tilted out of balance, and we have got to figure out what we do about that, and we are going to do our best to see if we can't provide some answers.

The CHAIRMAN. Thank you, Senator Riegle.

I want to thank you folks very much. You have certainly given us a graphic, specific picture of the very tragic human problems involved, and that can speak much more eloquently to us and to the Congress then all the statistics in the world.

You have done a fine job. Thank you very much.

The committee will stand adjourned.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follow:]

A GLOSSARY OF TERMS

A

ARBITRAGEUR.—a professional stock trader who deals in the stock of companies involved in takeover contests, or companies which seem likely to become involved in such contests in the near future.

B

BEAR HUG.—notification of a target company's management that a tender offer is imminent or under consideration. There are several variations: the "strong bear hug," in which the tender offer is made public, intensifying the pressure on the target company; the "teddy bear hug," an offer management believes it can fend off; and the "reverse bear hug," when the target company replies that it favors the merger, but at a much higher price than the one offered.

BIDDER.—the person, group or company making a tender offer for control of another company.

BLACK BOOK.—an outline of defensive tactics to be employed should a hostile takeover attempt be made.

BLOCK PURCHASE.—the acquisition of a large number of a company's shares. The purchaser can exert pressure on the company even without making a formal takeover bid—"greenmail" (see below) is a possible result.

BUSINESS JUDGMENT RULE.—a legal concept embodied in various State corporation laws which has provided management and boards of directors with virtual immunity from shareholder suits because their decisions can be challenged only on very limited grounds. Directors and managements of target companies often invoke the rule in defending themselves against shareholder suits which accuse them of acting in their own self-interest during takeover bids. Recent court decisions have lessened the immunity provided by the rule.

C

CREEPING TAKEOVER.—the gradual accumulation of a company's stock through purchases in the open market. Since Federal law requires no public disclosure of stock ownership or takeover intentions until one's holdings total 5 percent of a company's shares (see "section 13(d)"), a bidder may control a substantial portion of the target company's stock at the outset of a takeover contest.

CROWN JEWELS.—a firm's most valuable assets. To defend against a hostile takeover. the "crown jewels" may be sold or optioned to a third party, thereby making the company less attractive to the bidder.

D

DEFENSIVE TACTICS.—actions taken by a target company to resist a takeover.

DROP DEAD FEE.—a fee paid by bidders to lenders when a proposed acquisition fails and the lines of credit established to finance the acquisition are not used. This arrangement allows bidders to commit themselves to large acquisitions, often worth billions of dollars, without actually having to borrow the money and risk overextending themselves in the financial markets.

E

F

FAIR PRICE PROVISIONS.—corporate charter or bylaw provisions requiring a bidder to pay the same price for all shares purchased. The intention is to prevent two-tier takeover bids (which see), in which one price is offered for some of the target's stock, and a lower price for the remainder.

FREEZE-OUT.—a type of merger in which a group or company which has obtained a controlling interest in another company forces the remaining shareholders to give up their interest in that company.

FRIENDLY TAKEOVER.—a merger supported by the management and board of directors of the target company.

FRONT-END LOADED TENDER OFFER.—see "Two-Tier Tender Offer."

G

GODFATHER OFFER.—a tender offer so generous that the target company management cannot reasonably refuse.

GOLDEN PARACHUTES.—employment contract provisions that guarantee very substantial severance payments to top management if they lose their jobs as the result of a takeover.

GREENMAIL.—a payment received (some would say extorted) from a company by a "raider" who has purchased a block of the company's stock and threatens to make a hostile tender offer. In order to negate the threat, the company buys the block of stock from the raider at a premium, that is, it pays more than the going market price. As a result, the value of other outstanding shares often decreases, thereby injuring the other shareholders.

GREY KNIGHT.—a company which enters into a takeover contest between two (or more) other companies, and whose intentions are ambiguous and not entirely welcome to either party. In contrast, a "white knight" (see below) comes to the "rescue" of the target firm.

H

HOSTILE TAKEOVER.—a merger resisted by the acquired firm.

I

INVESTMENT BANKER.—a financial intermediary, one of whose functions is to advise firms involved in or contemplating mergers and acquisitions. An investment banker's services may include selecting target firms, formulating strategy and tactics, and arranging financing.

J

JONESTOWN DEFENSE.—defensive tactics so extreme as to appear suicidal. The term first appeared during the Bendix/Martin Marietta/Allied/United Technologies merger battle.

K

L

LADY MACBETH STRATEGY.—a strategy wherein a third party appears to come to the aid of a target company in a hostile takeover attempt, in the manner of a "white knight" (see below), but then changes allegiance and joins with the acquiring firm.

LEVERAGED BUYOUT.—a transaction in which a group of investors acquires and "takes private" a publicly-owned company (or a division or subsidiary of a firm). The acquisition is usually initiated by an investment banker, often in partnership with members of the firm's management. The transaction also depends on borrowing most of the purchase price, using the firm's assets as collateral. Leveraged buyouts have been undertaken to prevent hostile takeovers.

LOCKUP.—an agreement between a target company and a proposed acquiror giving that acquiror an advantage over other potential bidders. Lockups may include: a stock purchase agreement for treasury or unissued shares, an option to buy treasury or unissued shares, an option to buy certain assets, a merger agreement, and other provisions.

M

MINIMUM OFFERING PERIOD.—the shortest time a tender offer may remain open—20 business days under current Federal law.

MITE CASE.—the Supreme Court decision of *Edgar* v. *MITE,* 102 S. Ct. 2629 (1982), which struck down the Illinois tender offer law as an unconstitutional restriction on interstate commerce.

N

O

P

PAC-MAN DEFENSE.—a tender offer made by the target of a hostile takeover bid for the stock of the original bidder.

POISON PILL.—an issue of securities, usually preferred stock, designed to discourage a hostile merger bid. Upon completion of a hostile takeover, the typical "poison pill" stock becomes convertible into cash or into the common stock of the acquiring company. The effect is to raise considerably the cost of the acquisition.

PORCUPINE PROVISIONS.—corporate charter or bylaw provisions meant to deter takeover attempts. For examples, see "fair price provisions," "golden parachutes," "poison pill," and "supermajority provisions."

Q

R

RAIDER.—a person, group, or company attempting to execute a hostile takeover. The term is frequently applied to those who specialize in hostile takeovers.

S

SANDBAG.—a delaying tactic, in which a target company agrees to negotiate a takeover bid, but seeks to draw out the negotiations as long as possible, hoping that it will be saved by a "white knight" or otherwise achieve a more favorable outcome.

SATURDAY NIGHT SPECIAL.—a tender offer made without the prior knowledge of the target company, and open for only the minimum offering period. The term dates from the 1960's when the minimum period was only 5 business days (versus 20 under current law), and when announcing tender offers during the weekend was a common practice.

SCORCHED EARTH DEFENSE.—the use of extreme defensive tactics which threaten to leave the target firm a financial cripple. Two examples: scheduling all debt to come due immediately upon the completion of a takeover; selling the "crown jewels" (see above). In one celebrated case, a group of Houghton Mifflin's authors threatened to find other publishers were that firm taken over.

SECTION 13(d).—the section of the Securities Exchange Act of 1934, as amended by the Williams Act of 1968, which requires that notice be filed with the Securities and Exchange Commission [SEC], with the target company, and with each exchange on which the target's securities are traded, within 10 business days after any person or group acquires "beneficial ownership of 5 percent or more of a class of registered equity securities." The disclosure form (SEC schedule 13D) must include, among other things, the source of funds for the acquired securities, the purpose of the acquisition, and the buyer's future plans with respect to control of the target.

SECTION 13(d) WINDOW.—the 10 days between the acquisition of 5 percent or more of a firm's stock and the required public disclosure (see "Section 13(d)" above). During this period the acquiror may continue to buy the target firm's stock, and thus may own considerably more than 5 percent when the disclosure is made. (See also "Creeping Takeover," above).

SELF-TENDER.—a company's purchase of its own shares. This is frequently done to remove the shares from the reach of a hostile bidder, thereby lessening the prospect of the bidder's obtaining a majority of shares.

SHARK REPELLENT.—provisions in corporate by-laws designed to prevent hostile takeover bids (see also "Porcupine Provisions"). Also used for defensive tactics in general.

SHARK WATCHERS.—consultants who help corporations identify buyers of their stock, in order to provide early warning of takeover attempts..

SHOW STOPPER.—a lawsuit by the target company seeking a permanent injunction against the takeover bid.

SILVER WHEELCHAIRS.—see "Golden Parachutes."

STAGGERED DIRECTORSHIPS.—a defensive tactic—by staggering corporate directors' terms (having terms begin in different years, so that all directors are not elected at once), an acquiring company can be prevented from electing its own directors quickly.

STANDSTILL AGREEMENT.—an agreement whereby the bidder agrees to buy no more of the target's stock for a specified period of time.

SUPERMAJORITY PROVISIONS.—corporate bylaw provisions requiring that certain decisions, such as approval of a merger, pass by vote of a "supermajority" (70 to 80 percent) of shareholders.

T

TARGET.—the company that is the subject of a takeover bid.

TENDER OFFER.—a public offer to buy some or all of the stock of a corporation within a specified time period. Notice of the offer must be filed with the Securities and Exchange Commission on schedule 14D–1, disclosing, among other things, certain financial information about the bidder. The price offered is generally well above the current market price of the stock, to induce stockholders to tender their shares to the bidder.

TWO-TIER TENDER OFFER.—an offer to pay a certain amount per share, usually in cash, for a controlling interest in a corporation's stock, and then to acquire the remainder of the stock at a lower price, usually by means of an exchange of stock or a combination of cash and stock. Bidders using this technique hope that shareholders will "stampede" to tender their shares for the higher price offered on the "front end" of the deal, regardless of the wishes of the target company's management. This type of offer is also known as a "front-end-loaded tender offer."

U

V

W

WHITE KNIGHT.—a third party who agrees to acquire a target company, usually at that company's request, as an alternative to a hostile takeover by another bidder. The merger proposed by the "white knight" generally offers terms more favorable to the target company's management, and a higher price per share to stockholders.

X

Y

Z

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM ALAN GREENSPAN

Q.1. A great deal has been made out of the fact that corporate debt has been rising steadily. Among others, Federal Reserve Board Chairman Volcker, FDIC Chairman Seidman, and SEC Chairman Shad have expressed this concern.

Why is our relatively low corporate debt to equity ratio of such concern to many in this country, while Japan and Germany's much higher debt to equity ratio is not of similar concern to them?

A. 1. As I understand it, when corporate debt to equity ratios in both Japan and Germany are converted to market values, as distinct from the usually reported book values, the differences between the United States and Japan and Germany is much less.

Q.2. Please list and clarify exactly what abuses you believe are occuring in the conduct of hostile takeovers.

A. 2. I would list any actions that exist between an acquiring party and corporate management that infringes the rights of the shareholders of the target company. "Greenmail" is a clear and unambiguous infringment of rights of shareholders. "Golden parachutes" are too often solely in management's interest rather than shareholders' interests.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM ALAN GEENSPAN

Q. 1. Critics argue that takeovers should be severely restricted because they may cause job loss and community dislocations. Isn't it true that while takeovers can sometimes have near term effects, more often the absence of a change in management direction can so debilitate an industry or a company that massive job loss is the eventual consequence of a failure to adapt over time? How many jobs might have been saved in the steel industry, for example, if the management in that industry had been challenged 25 years ago?

A. 1. I am in general agreement with your point of view on this issue.

Q. 2. Some argue that takeovers draw available credit away from more productive uses. Does the credit used in takeovers adversely affect the credit markets or is it instead recirculated in the economy by shareholders?

A. 2. It is recirculated in the economy by shareholders.

Q. 3. Don't hostile takeovers or threatened takeovers such as Uniroyal or Disney, operate to move assets to more efficient uses?

A. 3. Most of the time they do, but I suspect there are instances in the which that is not the case.

Q. 4. The 1985 Annual Report of The Council of Economic Advisers states, "the best assurance an incumbent management has against a successful takeover attempt is a stock price that is high relative to outsiders' estimates of the potential value of the corporation's shares. Managements that allocate capital to higher valued uses, operate efficiently, and adopt capitalization structures responsive to prevailing financial market conditions are less likely to be subject to takeovers than other management groups. Consequently, in order to prevail in the external market for corporate control, it is not enough that an incumbent management believes that it is doing a proper job, or that it persuades stockholders that it is doing so. Instead, management must demonstrate that its performance is competitive with the performance of other potential managers, and the value of management's performance must be reflected in the corporation's stock price. In this fashion, the external market for corporate control disciplines managers who believe they have maximized the value of the corporation's shares when, in fact, they have not."

What is your response to the argument expressed here that if target companies had been managed to maximize shareholder wealth they would not have ended up as "targets"?

A. 4. That is essentially correct, with one major caveat. The recent high cost of capital has distorted the relative values of corporations, as I outline in my submitted testimony. The high cost of capital enforced a foreshortened time horizon for corporate results. Those managers who continued long-term facilities planning were accordingly perceived as producing suboptimal results. The managers' point of view, consciously or otherwise, was that the cost of capital would return to its more normal, lower, levels and activities focused on the future would, in the long-term, turn out to be a maximization of corporate value.

2
D'Amato — Greenspan

Q. 5. The 1985 Annual Report of The Council of Economic Advisers states

> "to the extent that government regulations impose costs on bidders, or reduce a bidder's chances for success, fewer takeover attempts will be made. This tends to insulate corporate managements from the competitive pressures of the external market for corporate control. Stockholders as a group will also suffer as a result of excessive regulation because it reduces the chance to earn takeover premiums."

How do you refute this argument?

A. 5. I wouldn't. I believe the argument is essentially correct.

Q. 6. What is your response to the following statement which appeared in the 1985 Annual Report of The Council of Economic Advisors?

> ". . . The current state of knowledge strongly indicates that further federal regulation of the takeover process, particularly insofar as it would make takeovers more costly, would be poor economic policy."

A. 6. With the exception of greenmail, I am in agreement.

Q. 7. The 1985 Annual Report of The Council of Economic Advisors states:

> "the available evidence, however, is that mergers and acquisitions increase national wealth. They improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management. They also help recapitalize firms so that their financial structures are more in line with prevailing market conditions. In addition, there is no evidence that mergers and acquisitions have, on any systematic basis, caused anticompetitive price increases."

The report goes on to state:

> ". . . There is no economic basis for regulations that would further restrict the merger and acquisition process."

Given the fact that mergers and acquisitions taken in the aggregate are beneficial to society and the economy would you propose somehow to distinguish between "good" and "bad" acquisitions?

A. 7. Were government to decide what was a good or bad acquisition, political decisions would soon put a premium on bad acquisitions.

3
D'Amato -- Greenspan

Q. 8. **The 1985 Annual Report of The Council of Economic Advisers states:**

> **"the evidence also suggests that abusive practices in the market for corporate control are limited largely to tactics employed by target managements who, in opposing takeover bids, defeat or deter tender offers at the expense of their stockholders and the economy."**

How do you defend the defensive actions of management and should legislation be introduced to eliminate these types of abuses?

A. 8. To the extent that target managements are perceived as breaching their fiduciary responsibility to corporate shareholders, legal action is prescribed. I am not sufficiently familiar with SEC regulations to know whether in all individual instances target management's inappropriate practices would be dealt with effectively.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
FELIX G. ROHATYN

Q.1. You state on pages 5 and 6 of your testimony that market speculation has become an integral part of the hostile takeover process. You note that "very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools are financed by junk bonds. Equally large pools of money are in the hands of raiders similarly financed. This creates a potentially interlocking set of relationships which has as its basic purpose the destabilization of a large corporation and its subsequent sale or break-up."

How, in your view, might a triad of investment bankers, arbitrageurs and raiders work together to put a company into play in order to reap huge profits for themselves at the expense of corporations and their employees?

A. 1. Investment bankers who arrange junk-bond financing for raiders receive very large fees in connection with takeovers. Frequently, a fee of 4% of the amount raised to finance the raider plus 1% of the amount involved when the raider acquires the target plus a significant percentage of any greenmail or other profit realized by the raider.

The raider makes its profit by acquiring a large stock position, frequently 10%-20% in the target through open-market purchases at prices substantially below the price at which it offers to acquire the target. Then, the raider makes an offer at a price above the market but significantly below what the raider believes it could realize by liquidating the target. The raider's offer forces the target to sellout to a white knight or radically restructure its capitalization and business, in each case, at a price higher than the bid by the raider or to pay greenmail to the raider.

Arbitrageurs buy large positions as soon as they learn that the raider is accumulating a position and they profit under any circumstances other than if the raider receives greenmail and there is no other transaction that results in a higher price for the target stock.

The high price paid by a white knight or the tremendous leverage necessary to achieve a restructuring of the capitalization of the target that will result in a higher market price forces reductions in research and development expenditures, capital investment expenditures and employment levels. The high cost of the junk-bond financing in the situations where the raider acquires the target forces the raider to either liquidate the target or make the same kind of business changes dictated by a restructuring.

2
Proxmire -- Rohatyn

Q.2. Please list and clarify exactly what abuses you believe are occuring in the conduct of hostile takeovers.

A. 2. The abuses in the conduct of hostile takeovers are:

a. Commencing tender offers without committed financing for the purpose not of acquiring the target but making a financial profit by forcing a white knight transaction, restructuring or greenmail.

b. Accumulation of large positions through open-market purchases that avoid the shareholder protections of The Williams Act.

c. The leaking of information to arbitrageurs for the purposes of "putting companies in play."

d. The use of partial and two-tier tender offers for the purposes of panicking shareholders into tendering their shares for the cash portion so as not to be left as minority shareholders to be squeezed out by the raider after it acquires control, frequently at a lower price in the form of junk bonds.

e. The escalation of defensive tactics such as shark repellents, poison pills, and non-voting stock in order to defend against the abusive offensive tactics of raiders.

f. The deterioration of the standards of business and financial conduct resulting from the takeover frenzy.

Q.3. Please clarify as explicitly as you can the specific abuses you see in the financing of these takeovers and how you would correct them.

A. 3. The basic financing abuse is too much leverage. The simple solution is to deny tax deductibility of the interest on debt incurred for the purpose of acquiring equity if the debt-to-equity ratio of the issuer of the debt is more than 2 or 3 to 1, on a pro forma basis.

3
Proxmire -- Rohatyn

Q.4. In your testimony you make the following specific recommendations, among others:

--"Require 100% financing commitments before allowing a tender offer to commence."

--"Lengthen the tender offer period to 60 days."

--"Limit the amount of below-investment grade paper, which can be carried by Federally and state-insured institutions."

Please provide us with the best arguments and rationale that you can to support each of these ideas.

A. 4. a. The present practice of raiders commencing indirect tender offers for multi-billion dollar companies based solely on a non-binding letter from an investment banker that it is confident that it can arrange financing to enable the raider to pay for the cash portion of the tender offer encourages the takeover abuses specified above. If fully committed financing were required it would eliminate many of these abuses and help assure that the financial institutions providing the commitments had some confidence that a reasonably structured deal could be effectuated.

b. Lengthening the tender offer period to 60 days would alleviate the pressure on the board of directors and the shareholders of the target and assure better decisions and sufficient time to attempt to achieve the best result for the shareholders. It would also give government agencies more time to evaluate the disclosure and regulatory issues.

c. Insured institutions basically substitute government credit for their own in assuring depositors, creditors and policyholders and therefore are freed from any market restraint on the quality of their assets. This puts the insuring government at risk on the junk-bonds originally issued by corporate raiders, an obviously inappropriate and undesirable situation.

Q.5. A great deal has been made out of the fact that corporate debt has been rising steadily. Among others, Federal Reserve Board Chairman Volcker, FDIC Chairman Seidman, and SEC Chairman Shad have expressed this concern.

Why is our relatively low corporate debt to equity ratio of such concern to many in this country, while Japan and Germany's much higher debt to equity ratio is not of similar concern to them?

A. 5. We have a much different system from Japan and Germany. The most significant difference is that the institutions that provide the debt financing to the higher leveraged companies in those countries usually have very significant equity interests and the tradition is not bankruptcy in the event of default on debt, but reorganization under the sponsorship of the institution. In other words, the debt in those countries is much more like equity. In addition, the most fundamental difference is the fact that Japanese and German companies do not assume indebtedness to pay out to the stockholders, as is often done here. They borrow money to invest in the future of the business and to improve their competitive position. That is an absolutely critical difference.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM FELIX ROHATYN

Q. 1. You mention the Boesky scandal and the greed that is driving wall street. With regard to corporate takeovers, are these transactions driven by greed alone or is there some economic justification of them? Will investors participate in these takeovers if they are economically **unsound? Can you cite from your experience any examples of mergers in which you have participated that were economically irrational?**

A. 1. It is impossible to generalize with respect to the economic justification or lack of justification of corporate takeovers. Some have very strong economic justifications; some have very weak ones. Participation of investors will **depend upon their own perception;**

Q. 2. You suggest that greed and corruption have resulted in the proliferation of hostile takeovers and increased the incidence of insider **trading. Does insider trading occur with the same or greater frequency in hostile offers than in friendly offers?**

A. 2) I suggested in my testimony that the abuses in the takeover area are heavily focused in the hostile junk bond takeover field and the trading activities connected **therewith;**

Q. 3. Do you think the merger of GE and RCA was driven by the climate of speculation to which you referred in your statements? Are you aware of any investigations, settlements or convinctions for insider trading that have resulted from the GE's acquisition of RCA?

A. 3) The merger of GE and RCA was a friendly, negotiated merger, based essentially on industrial strategies;

Q. 4. In the past you have stated that one of the justifications for congressional action on takeovers is the safety of financial institutions. However, aren't most of the problems threatening our financial institutions unrelated to takeovers?

A. 4) I believe that some financial institutions holding large portfolios of junk bonds could get into difficulties **in a recession;**

2
D'Amato — Rohatyn

Q. 5. What percentage of all corporate takeover activity in the last 4 years has been financed by junk bonds?

A. 5) Of the takeover activities financed by junk bonds, one has to add takeovers that were the result of junk bond raiders and consumated by third parties. This would include many of the large oil company takeovers amounting to probably $30 or $40 billion alone. It would also include the restructuring of major oil companies as well as other company restructurings triggered by junk bond raiders;

Q. 6. You aren't arguing that we should impede corporate takeover activity as a way to curb insider trding, are you? What more can we do as legislators to discourage and penalize insider trading? Isn't it up to the firms involved to police themselves more effectively?

A. 6) Insider-trading should be curbed by giving the SEC more resources to extend their surveillance and by harsh penalties to individual law-breakers;

Q. 7. Is the leveraging of a company that results from hostile takeover activity any worse than the leverage that results from a leveraged buy-out?

A. 7) No.

Q. 8. On page 3 of your testimony, you propose that congress override state takeover statutes and other defenses designed to turn away bona fide bidders and permit management entrenchment. However, on page 7 you propose limiting the right to vote on major corporate matters to shareholders who have held stock for less than one year. Doesn't such an encumbrance on a shareholder's voting right provide management with the ability to entrench themselves by discouraging bonafide bidders? How long does an average individual shareholder hold his securities in a particular company? On average how long does an institutional investor hold on to its investment in a particular company?

A. 8) I do not believe it will have that effect, but that is a matter for individual judgement;

3
D'Amato -- Rohatyn

Q. 9. Although you cite the negative implications of corporate takeover activity upon the economy, a review of some of the largest takeover transactions of 1986 reveals that your firm, Lazard Freres has participated in some of these transactions. Did you directly participate in any of these transactions? Have you tried to dissuade your firm from participating in these transactions? What has been their response? Since you feel so strongly about this issue don't you feel your statements today undercut by the fact that at least some of your firms earnings for 1986 of which you receive a percentage is directly attributable to your firm's participation in these transactions? How do you expect the members of this committee to be receptive to your arguments when the members of your firm are not?

A. 9) As you will see throughout my testimony and other statements I have made on the subject, I have no objection whatsoever for takeovers since for thirty years I have made my living by negotiating them. I do object strenuously to unfair practices, excessive speculation, unfair structuring and over-leveraged balance sheets. I believe that many members of the financial community agree with these views;

Q. 10. Either you or one of your colleagues in the investment banking community was reported to have stated that: "the only difference between a hostile takeover and a friendly offer is $5.00 per share." Are the impacts upon the debt burden of the surviving company or upon the economy in general any different in friendly offers and leveraged budgets than in hostile tender offers? Does your firm engage in only friendly transactions? Do you believe that the insider trading is more prevalent in hostile transactions or friendly takeovers? Would you be surprised to learn that sec statistics demonstrate that insider trading is more prevalent in friendly rather than hostile takeovers?

A. 10) I did not make the statement quoted in your question. We have engaged and will continue to engage in both friendly and hostile takeovers provided they are fair and soundly financed;

Q. 11. Do you believe that the payment of greenmail to a potentially hostile raider is preferable to the initiation of a hostile takeover?

A. 11) I believe greenmail should be outlawed;

4
D'Amato -- Rohatyn

Q. 12. Would the shareholders of the company paying greenmail benefit more from the elimination of a potential hostile raider than from the execution of a successful hostile takeover initiated by a bidder?

A. 12) Same as 11.

Q. 13. In September 1984, the SEC released a study concluding that greenmail payments adversely affect the shareholders of the greenmailed company. The report stated:

> "the evidence suggests that non-participating shareholders suffer substantial and statistically significant share price declines upon the announcement of targeted repurchases at premiums above market value. The overall impact on share prices from the date the initial foothold position is established to the date the block is repurchased is also negative . . . We conclude that the overall impact of targeted share repurchases on the wealth of non-participating target shareholders is negative. The stock price evidence indicates that the magnitude of the losses to non-participating target shareholders is at least equal to the wealth loss implied by the cash premium paid for the block purchase."

A. Do you agree with the SEC's conclusions?

B. Do you believe that legislation is required to restrict or prohibit the payment of greenmail?

A. 13) Same as 11.

Q. 14. The 1985 Annual Report of The Council of Economic Advisers states,

> "the best assurance an incumbent management has against a successful takeover attempt is a stock price that is high relative to outsiders' estimates of the potential value of the corporation's shares. Managements that allocate capital to higher valued uses, operate efficiently, and adopt capitalization structures responsive to prevailing financial market conditions are less likely to be subject to takeovers than other management groups. Consequently, in order to prevail in the external market for corporate control, it is not enough that an incumbent management believes that it is doing a proper job, or that it persuades stockholders that it is doing so. Instead, management must demonstrate that its performance is competitive with the performance of other potential managers, and the value of management's performance must be reflected in the corporation's stock price. In this fashion, the external market for corporate control disciplines managers who believe they have maximized the value of the corporation's shares when, in fact, they have not."

What is your response to the argument expressed here that if target companies had been managed to maximize shareholder wealth they would not have ended up as "targets"?

5
D'Amato -- Rohatyn

Q. 15. The 1985 Annual Report of The Council of Economic Advisers states

> "to the extent that government regulations impose costs on bidders, or reduce a bidder's chances for success, fewer takeover attempts will be made. This tends to insulate corporate managements from the competitive pressures of the external market for corporate control. Stockholders as a group will also suffer as a result of excessive regulation because it reduces the chance to earn takeover premiums."

How do you refute this argument?

Q. 16. What is your response to the following statement which appeared in the 1985 annual report of the council of economic advisors?

> ". . . The current state of knowledge strongly indicates that further federal regulation of the takeover process, particularly insofar as it would make takeovers more costly, would be poor economic policy."

Q. 17. The 1985 annual report of the council of economic advisors states:

> "the available evidence, however, is that mergers and acquisitions increase national wealth. They improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management. They also help recapitalize firms so that their financial structures are more in line with prevailing market conditions. In addition, there is no evidence that mergers and acquisitions have, on any systematic basis, caused anticompetitive price increases."

The report goes on to state:

> ". . . There is no economic basis for regulations that would further restrict the merger and acquisition process."

Given the fact that mergers and acquisitions taken in the aggregate are beneficial to society and the economy would you propose somehow to distinguish between "good" and "bad" acquisitions?

Q. 18. The 1985 Annual Report of The Council of Economic Advisers states:

> "the evidence also suggests that abusive practices in the market for corporate control are limited largely to tactics employed by target managements who, in opposing takeover bids, defeat or deter tender offers at the expense of their stockholders and the economy."

How do you defend the defensive actions of management and should legislation be introduced to eliminate these types of abuses?

A. 14, 15, 16, 17 & 18)

I enclose for your information, articles I have written on this subject along with previous testimonies which I believe will give you my views on these issues. I believe you will also find them covered in one way or the other in the record of the hearings at which I participated this year and two years ago.

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D'Amato -- Rohatyn

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On a Buyout Binge and a Takeover Tear

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By Felix G. Rohatyn
05/18/84
WALL STREET JOURNAL (J)
TENDER OFFERS, MERGERS, ACQUISITIONS (TNM)

I have been in the investment banking business for 35 years. I was a governor of the New York Stock Exchange and chairman of its so-called "Crisis Committee" in the late 1960s, the so-called "Go-Go years." I make my living doing mergers and acquisitions, and by giving advice to corporate America. What is happening in the financial markets today bears the same relationship to what happened in the "GoGo" years of the 1960s as Caesars Palace bears to the local church bingo game. Every kind of financial instrument is being created to lure individuals into believing they are investing when they are really speculating. Variable-rate mortgages to give the home buyer the illusion he has a cheap mortgage; options, straddles, commodity futures, foreign-exchange contracts, venture-capital funds, "Junk bonds." We are turning the financial markets into a huge casino.

Individuals are not the only speculators. A transaction called "leveraged buy-out" has swept corporate America. This transaction essentially turns public companies into private companies mostly by borrowing against their own assets and shrinking their equity dramatically. Thus a public company with, say, $100 million of debt and $900 million of equity is turned into a private company with $900 million of debt and $100 million of capital.

This has two consequences, both highly speculative. First, it bets the company on a combination of continued growth and lower interest rates, with no margin for error. Second, it substitutes debt for permanent capital, which is exactly the opposite of what our national investment objectives ought to be.

These LBOs have increased in size, culminating in Esmark's $2.5 billion transaction announced this month and the proposal to take Gulf Oil private for $12 billion some time ago. Although I have no hard numbers, I would guess that, up to now, more than $10 billion of such transactions have taken place. Credit has come from banks and pension funds, whose investment advisers want to outperform the competition. If, in the next year or two, we run into an inflationary recession, with higher interest rates and lower economic activity, there are going to be major casualties in this field. Pension-fund managers will wonder why they did not simply buy 12% government bonds, and banks will have another major loan restructuring area. This is speculation on a major scale.

In the field of takeovers and mergers, the sky is the limit. Not only in size (four recent oil company transactions alone added up to about $35 billion), but in the types of large corporate transactions, we have often gone beyond the norms of rational economic behavior. The tactics used in corporate takeovers, both on offense and on defense, create massive transactions that greatly benefit lawyers, investment bankers and arbitragers, but often result in weaker companies and do not treat all shareholders equally and fairly. The new vocabulary of our business is a reflection of this development: Two-tier tender offers, Pac-Man and poison-pill defenses, crown-jewel options, greenmail, golden parachutes, self-tenders all have become part of our everyday business. They are wonderful for the profitability of our business in the short run, but I believe they are reaching a point where the integrity of our financial markets is in question, and, after all, that has been the basis of the success of our free-enterprise system. In the long run, we in the investment banking business cannot benefit from something that is harmful to our economic system.

I have no specific answers to these trends except to note that bubbles always burst. Tighter regulations on the use of credit or the tax deductibility of interest in certain transactions, reform of takeover regulations, tighter standards on uses of pension funds will, sooner or later, be the result of what is happening today.

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* Mr. Rohatyn is a senior partner of Lazard Freres & Co. This is excerpted from his recent speech to the American Society of Newspaper Editors.

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D'Amato -- Rohatyn

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION, AND FINANCE
OF THE
COMMITTEE ON ENERGY AND COMMERCE

TESTIMONY OF FELIX G. ROHATYN
May 23, 1984

Mr. Chairman, Members of the Committee,

Thank you for inviting me to appear before the subcommittee. The issues you are considering are very important ones, important to the integrity of the financial markets and to the proper functioning of the capital-raising system.

I am a senior partner in the investment banking house of Lazard Freres, where I started my career thirty-five years ago. My work consists mainly of advising corporate clients as to financial matters in general, and mergers and acquisitions specifically. I was a governor of the New York Stock Exchange from 1968 to 1972, and the Chairman of its so-called "Crisis Committee" during those troubled years. I serve on the Board of Directors of six large New York Stock Exchange - listed corporations.

I have seen the evolution of mergers and takeovers from the conglomerate merger era of the 1960s, through the growing acceptability of large, "hostile" takeover bids of the 1970s, to the current frenzy of huge transactions, with offensive and defensive tactics that often go beyond the norms of rational economic behavior. I am not here to argue against the ability of corporations to make acquisitions or to reject being acquired; I believe in the present system and, in addition, this is an exceedingly important and profitable part of our business. I do believe, however, that some existing practices have to be curbed on the public policy issue of fairness to all shareholders. This is the cornerstone of our securities legislation which has given us the greatest capital markets in the world and has been a critical part of our economic and social progress.

I believe that the same principles should apply to all corporate acquisitions, whether "friendly" or "hostile". Indeed, experience has shown that many initially "hostile" bids have turned "friendly" when the initial price was raised, greater benefits provided and no "white knight" could be found. The converse is equallly true, namely that many a "white knight" turned out to be anything but friendly after achieving control, to the great chagrin of the acquired company. The basic principles involved are that _all_ shareholders should be treated alike, that they should be allowed ample time to make their decisions, that they should be provided with ample disclosure to help them with their decisions and that these principles be applied equally, in a takeoer contest, on offense as well as on defense. The practical implementation of such an approach applied to today's takeover practices would be as follows:

1) _As to the "Offensive" side of a takeover bid._

a) The "two-tier" tender offer should be prohibited. If a tender offer involves a transaction in two steps, both steps should be at the same price. If the first stepis cash and the second step involves securities of the acquirer, the value of the securities, as of the date of the initial tender offer, should have to be approximately the same as the cash portion of the tender offer. This would eliminate, to a large extent, the present unfairness created when the benefits of a very high-priced first step benefit largely professional investors and are used to create a stampede, while the less-informed, smaller stockholders receives the lower priced second step.

b) The tender offer should remain in effect for a minimum of sixty days thereby giving all shareholders ample time to weigh their decisions and evaluate their alternatives.

c) Any acquisition, by tender offer or otherwise, involving, in the aggregate, more than 25% of the total market value of the acquiring company, should be subject to the vote of its shareholders. This would have the same rationale as the present New York Stock Exchange rule requiring shareholder approval for the issuance of more than 18% of a company's shares. Shareholder dilution can come about as a result of a large acquisition for cash, which ultimately has to be refinanced, as well as the direct issuance of stock, and therefore shareholder approval, in all cases involving significant acquisitions, seems appropriate.

A sixty-day tender offer period provides appropriate time for shareholder meetings.

d) Any acquisition of more than 20% of a company's stock should require an offer for 100%. This avoids the "creeping tender", acquisition of control without a premium going to all shareholders, freeze-out of the minority, etc. The 20% levels permits corporate affiliations where control is not an issue, where consolidation for accounting purposes is important and where there are valid business reasons for an important minority investment.

The nearest equivalent is the British rule requiring a 100% offer when going over 29%.

2) As to the "Defensive" side of a takeover bid.

I support the thrust of the SEC's recent recommendations, but I would propose variations which would be as follows:

a) Any stock repurchase program by a company subject to a tender offer should be executed only by a self-tender of at least equivalent duration as the acquiring tender and should be subject to shareholder approval.

b) A company which is the subject of a tender offer should be prohibited from issuing or optioning securities carrying in excess of 10% of its aggregate voting rights without shareholder approval.

c) A company subject to a tender offer should be prohibited from selling, encumbering or optioning to a third party assets having a value of 10% or more of the company's aggregate market value without shareholder approval.

d) A company should be prohibited from reacquiring more than 3% of its shares from any one holder without shareholder approval, unless it is part of a self-tender to all shareholders.

e) A company subject to a tender offer should be prohibited from entering into "golden parachute" contracts. without shareholder approval.

It seems to me that such a total package would be essentially neutral as to benefitting either offense or defense by lengthening the time frame of an offensive tender offer and subjecting all major corporate decisions to shareholder approval. It removes the need for hasty and often exceedingly self-detructive defensive actions and avoids the need to deal with the "business judgement" rule by making major coporate structural changes subject to shareholder vote.

The "business judgement" rule is entrenched in practically every state law and is a valid concept in most circumstances. However, it presupposes that corporate Directors are totally independent of management and that legal and financial advisors are totally independent and solely responsible to totally independent directors. We all know that in the real world these relationships are infinitely more complicated and the question of independence has an infinity of shadings. The system does work, however, and rather than tamper with the "business judgement" rule and all that would involve, I believe it is more advisable to simply remove certain major coporate structural decisions from the responsibility of directors exercising their business judgement and put it back into the hands of the shareholders where it properly belongs. Speaking as a corporate director, who has had to exercise his business judgement many times in similar cases, and who has heard the same advice from eminent counsel about the "business judgement" rule, I would feel much more comfortable if, in the matters I referred to above, the decision had to be ratified by the shareholders.

There are other areas of concern that require close scrutiny. The disposition and the voting of shares owned by employees in profit-sharing or pension trusts, the relationship of the trustee to the Corporation and to the employee, all should be reviewed in the light of present practices. I do not know whether this comes under the jurisdiction of this Committee or under the ERISA laws, but it should not be ignored. The excessive use of credit in certain types of Leveraged-Buy-Outs are also cause for concern, but are probably not relevant to these hearings.

In summary, I would suggest that legislation is required in those areas which, at present affect negatively the principle of equal treatment of all shareholders. This is true both on the offensive as well as on the defensive side of tender offers. The suggestions I have made should be viewed as part of one package which would favor neither one side nor the other in a takeover bid, but would rather protect all shareholders. The present environment is more and more reminiscent of the type of speculative excesses and corporate behavior of the late 1920s which brought about the securities legislation of 1933 and 1934. They also cost a great many people their life savings and put into question the integrity of our financial markets. I believe it will serve the best interests of all concerned, the financial community as well as the corporate community if the present situation is brought under greater control.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM LLOYD CUTLER

Q.1. You have expressed considerable concern, at one time or another, with certain aspects of the financing of hostile takeovers. Would you clarify as explicitly as you can the specific abuses you see in the financing of these takeovers and how you would correct them?

A. 1. The abuses about which I testified are: (a) the circumvention of the margin requirements of the Federal Reserve Board which limit borrowings for the purchase of stock to 50% of the market value of the stock and (b) the continuing availability of a tax shelter for the creation of excessive debt-to-equity ratios. The proposed corrections are set forth in my direct testimony.

Q.2. A great deal has been made out of the fact that corporate debt has been rising steadily. Among others, Federal Reserve Board Chairman Volcker, FDIC Chairman Seidman, and SEC Chairman Shad have expressed this concern.

My question is the following: Why is our relatively low corporate debt to equity ratio of such concern to many in this country, while Japan and Germany's much higher debt to equity ratio is not of similar concern to them?

A. 2. The higher debt-to-equity ratios of Japan and the Federal Republic of Germany are really not comparable. Most major Japanese industrial firms are linked together with other firms of the same group in a "tiger tail" relationship, in which the firms collectively own virtual control blocks of the shares of each of the related firms. The group usually includes a major bank which supplies dependable long-term financing at low interest rates through all phases of the business cycle and acts in the role of controlling shareholder to shake up management when necessary. In Germany the major banks own large equity holdings in the major industrial firms, sit on their supervisory boards and also provide dependable long-term financing at low interest rates through all phases of the business cycle. Although the German and Japanese industrial firms are more highly leveraged than American firms, they are sheltered from the vagaries of the business cycle by low interest rates and by the all-weather financial support of the industrial or banking group to which they belong. The "tiger tail" in Japan and bank ownership in Germany also protects them from takeovers.

Q.3. I would like you to make a list and clarify exactly what abuses you believe are occuring in the conduct of hostile takeovers.

A. 3. As the first paragraph of my statement indicates, I believe there is a good deal to be said on both sides of the argument about whether the takeover phenomenon has a benign or detrimental effect on the efficiency of particular firms. My major concerns relate to the resulting decline in the equity capitalization of companies which defend against or succumb to hostile takeovers. As indicated in my reply to the question from Senator Sasser, I am also concerned that if too many major companies become "lean and mean," their meanness will detract greatly from the social value of the business corporation and public confidence in the free enterprise system. In general I believe there are abuses on both the offensive and defensive sides of takeover battles and that the legal rules of engagement should be changed on both sides along the lines recommended to the Committee by Martin Lipton.

Q.4. Concerning your comments on the Federal Reserve's margin requirement authority, you call for more stringent margin requirements than those the Federal Reserve now has in effect. Should this Committee mandate more sweeping margin rules by statute to restirct the use of borrowings for stock purchases in takeover situations?

A. 4. With respect to the Federal Reserve margin requirement, if the Committee agrees with my view that the margin requirement should be tightened, I would recommend that this position be set forth in a letter to the Federal Reserve Board and that, if the Board does not itself tighten up the rules, the Committee should consider introducing appropriate legislation.

Also attached is an article on the subject of the margin rules and takeovers written by my partner Michael S. Helfer. I request that it be made part of the hearing record.

FINANCING

The Federal Reserve's Stand On Junk Bond Takeovers

Michael S. Helfer and William D. Brighton

The Fed put itself in the eye of a hurricane when it proposed to regulate junk bond-financed deals under its securities margin powers. Was the final product worthier of a tempest in a teapot?

RULINGS ON THE MEANING of stock purchase margin rules are not usually the stuff of newspaper headlines. The Federal Reserve Board's split decision on January 8, 1986, holding that the margin rules apply to junk bond-financed takeovers by shell corporations, was the exception. It made headlines all across the country. The actual impact of the Fed's decision, however, will probably be a lot less than one would think from all the ink spilled to report it.

We believe that the Fed's decision was correct as a legal matter, that it is so narrow that it will not itself significantly reduce the number or size of takeover attempts, and that the ruling leaves open questions with which the Fed and the courts will have to grapple in future takeover battles.

The margin rules are promulgated by the Fed pursuant to Section 7 of the Securities Exchange Act of 1934. Section 7 directs the Fed, "for the purpose of preventing the excessive use of credit for the purchase or carrying of securities," to promulgate regulations establishing the maximum amount of credit that can be "initially extended and subsequently maintained on a security."

The Fed has regulations governing margin credit by banks (Regulation U), by broker/dealers (Regulation T), and by other lenders (Regulation G), such as insurance companies and financial services and other companies not covered by Regulations U or T. Regulation G is the one involved in the junk bond decision because banks and broker/dealers subject to the other regulations typically are not (for legal and other reasons) purchasers of junk bonds issued in connection with takeover attempts.

The pertinent part of Regulation G is Section 207.3(b), which provides:

> No lender shall extend any purpose credit, secured directly or indirectly by margin stock in an amount that exceeds the maximum loan value of the collateral securing the credit.

This little sentence has a lot of requirements. For it to be applicable, (a) a lender must (b) extend credit (c) for the purpose of acquiring (d) margin stock, and the loan must be (e) directly or indirectly secured by

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the margin stock. If these conditions are met, then (i) the loan cannot exceed the maximum loan value of the margin stock. The maximum loan value of margin stock under all of the margin rules, including Regulation G, is 50 percent of the market value of the margin stock that secures the loan.

The Fed's January 8 interpretation of Regulation G grew out of its consideration of a series of petitions filed by target companies in 1985 asking the Fed to hold that the junk bond financing to be used by a hostile acquirer would violate Regulation G.

The first of the petitions was filed in April 1985 by Unocal Corp., which was the target of a takeover attempt by Mesa Petroleum Co. For present purposes, the takeover financing scheme can be summarized as follows. Mesa created a shell company — generically, "Newco" — which planned to sell its own debt securities in a private placement to certain institutional and other sophisticated investors. These debt securities were, in the parlance of Wall Street, "junk bonds" — that is, high-yield, below-investment-grade debt.

Newco was to use the money raised by the sale of the junk bonds to purchase Unocal stock in a cash tender offer. Indeed, the junk bond buyers were not required to put up their money until and unless enough stock was tendered to make the tender offer successful. Mesa intended ultimately to merge Newco with Unocal, but, because it would own only 50.1 percent of Unocal's stock after the tender offer, it could not force the merger to occur over the objection of the Unocal board (unless it later bought additional Unocal stock).

Violations are alleged

Unocal argued that the financing scheme violated Regulation G. In particular, Unocal said that all the requirements of Section 207.3(b) were met because:

(a) The purchasers of the junk bonds were "lenders" within the meaning of Regulation G since they were acting in the ordinary course of their business and would each acquire more than $200,000 of Newco's junk bonds;

(b) By purchasing Newco's junk bonds the lenders were "extending credit" to Newco;

(c) The credit was "for the purpose of" buying Unocal stock because that is what Newco told the junk bond buyers;

(d) Unocal stock was clearly "margin stock" because it was listed on the New York Stock Exchange;

(e) While the junk bond loans purported to be unsecured, they were in fact "indirectly secured" by the Unocal stock, because Newco had no other assets of any consequence, and the sophisticated lenders involved would not loan Newco nearly $2 billion unless they were relying on the stock; and

(f) The amount of the junk bond loans substantially exceeded 50 percent of the market value (even at the tender offer price) of the Unocal stock that Newco would own.

Secured by stock

There was no real dispute about any of these points except one: whether the junk bond loans were "indirectly secured" by the Unocal stock that Newco planned to buy in its tender offer. That point was vigorously disputed by Mesa and its investment banker, primarily on the ground that the junk bonds expressly stated that they were unsecured obligations of Newco and contained no legal restrictions on Newco's sale or disposition of the Unocal stock. The matter seemed ready for action by the Fed when Mesa terminated its effort to take over Unocal, thereby rendering Unocal's petition moot.

The next petition was filed in September 1985 by Revlon, which was the target of a takeover attempt by Pantry Pride Enterprises Inc. The financing scheme here was different in several respects from the Unocal scheme.

First, the junk bonds were to be issued by Pantry Pride — an operating company with some assets and income — rather than by its Newco. Revlon argued that this did not matter because the amount of the junk bond loans substantially exceeded the amount that Pantry Pride could borrow on the basis of its own assets and cash flow if it did not (through its Newco) own the Revlon stock.

Second, the junk bonds were registered with the SEC as a public offering, rather than being privately placed without registration. This allowed Pantry Pride to argue that, under prior Fed ~~stock~~ staff positions dealing with public offerings of debt securities, the junk bonds were not "extensions of credit." Revlon's response was that because the minimum purchase of junk bonds was $2.5 million, the public offering exception (even if it existed) was inapplicable. The Fed did not act on the Revlon petition and ultimately Revlon was acquired by Pantry Pride.

In October 1985, Pacific Lumber Co., the target of a takeover attempt by MAXXAM Group Inc., filed a petition with the Fed invoking Regulation G. The MAXXAM financing scheme was similar to the one involved in Revlon. Once again the Fed did not act and the target was acquired.

Finally, although it apparently did not involve a formal petition to the Fed, Union Carbide Corp., the target of a takeover attempt by GAF Corp., brought its situation to the attention of the Fed in connection with the Fed's consideration of the interpretation of Regulation G. Like the Revlon and Pacific Lumber schemes, and unlike the Unocal scheme, the Union Carbide financing involved the issuance of junk bonds by an operating company (GAF in this case) rather than by a shell.

A split vote

On December 6, 1985, while it had no formal petition before it on the matter, the Fed announced a proposal to adopt an interpretation of Regulation G to the effect that debt securities issued by shell corporations in connection with a takeover attempt would be deemed "indirectly secured" by the target's stock and would, therefore, be subject to the margin rules. The Fed invited comment (until December 23, 1985) on its proposed interpretation, although it said it was not required to do so under the Administrative Procedure Act. The Fed voted 3–2 to take this action. Vice Chairman Preston Martin and Governor Martha R. Seger voted against the proposed interpretation. Chairman Paul A. Volcker and Governors Emmett J. Rice and J. Charles Partee voted in favor; Governor Henry C. Wallich was not present, and the remaining seat was vacant.

The comment period was short, but the comments were many and vigorous. In general, the corporate community supported the Fed's interpretation, as did a number of senators and congressmen. Several investment bankers opposed it vigorously, though there were supporters among investment bankers too. The comment that got the most attention was the one from the Reagan administration: a 43-page brief submitted on behalf of the Departments of Justice and the Treasury and four other agencies that argued in strong terms that the Fed's proposed interpretation was inconsistent with Regulation G, unwarranted as a matter of policy, and amounted to an unlawful rulemaking in violation of the Administrative Procedure Act.

The Fed did not accept the administration's arguments. On January 8, 1986 — at an open meeting that apparently drew record public attendance — it adopted an interpretation of Regulation G that generally follows the one it proposed in December. The vote was 3–2, just as it had been in December.

Diluting the impact

However, the protests against the interpretation had their effect. The interpretation, as adopted, stresses, in a way that the proposal did not, that the Fed intended to deal only with the issuance of debt by shell corporations. As originally proposed, the interpretation would clearly have subjected the Mesa-Unocal financing scheme to Regulation G, and would have left open the possibility that the margin rules would also apply to the Pantry Pride-Revlon scheme. The commentary accompanying the final interpretation, on the other hand, makes clear that the interpretation does not apply to the financing schemes involved in the Pantry Pride-Revlon or GAF-Union Carbide battles.

Junk Bond Funding for M&A

Junk bonds provided $6.23 billion to finance mergers and acquisitions in 1985, according to the credit research department of Morgan Stanley & Co. That amount was 38.2 percent of the $16.29 billion in below-investment-grade debt securities that, Morgan Stanley estimates, were issued last year. It represents less than 5 percent of the $140 billion value that *Mergers & Acquisitions* reported for m&a transactions in 1985. According to Martin Fridson and Fritz Wahl, authors of a Morgan Stanley report, six deals valued at more than a billion dollars in 1985 involved some junk bond financing. Among them were Coastal Corp.'s $2.5 billion acquisition of American Natural Resources Inc. and the leveraged buyouts of Storer Communications Inc., for $1.5 billion, and Levi Strauss & Co., for $1.1 billion. The authors concluded that although it is increasing, junk bond financing is not the driving force behind an increase in hostile takeover activity. The authors noted that the $10.06 billion of junk bonds issued in 1985 for other corporate finance purposes itself was greater than the total amount issued in any year before 1984.

M&A

The core of the Fed's interpretation consists of its view — sometimes referred to in the commentary as a "presumption" — that "debt securities issued by a shell corporation to finance the acquisition of the margin stock of a target company are indirectly secured by the margin stock for purposes of the restrictions on lending in the margin regulations." While the debt securities involved in such takeovers are ordinarily junk bonds, the interpretation is not technically limited to situations in which junk bonds are involved.

A shell corporation, as the Fed used that term in the interpretation, is an entity (whether in corporate or partnership or other form) that has "virtually no business operations, no significant business function other than to acquire and hold the shares of the target company, and substantially no assets or cash flow to support the credit other than the margin stock that it has acquired or intends to acquire." In this situation, the Fed concluded, "the only significant asset available to support the credit is the margin stock and, therefore, the lender must be relying on that stock as collateral to secure repayment."

The Fed stressed several times that the interpretation applied only "to the shell corporation financing arrangements of the type presented in the Mesa-Unocal transaction." Other transactions "involving different facts," said the Fed, "are not covered by this interpretation; they will continue to be covered by existing law, regulations, and interpretations."

The legal view

In the narrow factual circumstances with which the interpretation deals, there is little doubt that the Fed is correct as a legal matter in its interpretation of Regulation G.

The Fed has long recognized that a wide variety of arrangements as to collateral, well short of a formal security interest, can protect the interest of the lender sufficiently to create "indirect security" within the meaning of the margin rules. Indeed, the definition of "indirectly secured" in Regulation G states that it "includes" certain described "arrangements" — a phrasing that, as the Fed said in its commentary here, "means that the factors identified in the regulation are intended to be illustrative of the circumstances in which debt may be found to be indirectly secured by margin stock and not a comprehensive recital of such circumstances."

Thus, the regulation itself permits the Fed to examine the economic realities of the arrangements between the shell company and the junk bond buyers even though those arrangements do not involve a type of security specifically mentioned in the definition of "indirectly secured."

Once one looks at the economic realities, it is clear that the institutional investors who buy junk bonds from a shell corporation in the takeover context are making a margin loan. By definition, the only substantial assets of the shell will be the target's stock. Sensible people do not lend millions (or billions) of dollars without some basis for getting repaid, and in the shell company case, the only security available is the target's stock owned by the shell.

On this score, as the Fed stated, the shell company situation is indistinguishable in principle from the investment company situation, where it has long been the rule that "loans to an investment company, the assets of which consist almost entirely of stock, are regarded as indirectly secured by that stock, since the lenders could not in good faith lend to the company without reliance on the stock."

Aiming for a merger

The contrary argument is that the junk bond buyers are really looking to the assets of the target company as security for repayment. But the fact that the acquirer is seeking control of a target company does not make Regulation G inapplicable, since the Fed has for many years interpreted the margin rules to "apply to credit used to acquire a controlling interest in a corporation by purchasing the stock of that corporation" where the credit otherwise meets the requirements of the rules.

More importantly, the shell company cannot get control of the assets of the target until and unless it can force a merger. If the takeover is contested, it may be months or years, if ever, before the shell and the target merge and the target's assets become available to pay off the shell's junk bonds. As the Fed said in issuing the interpretation, at the time the junk bond buyers make their commitment to lend to the shell — the relevant time for determining the applicability of the margin rules — the lender cannot reasonably be thought to be relying on the target's assets rather than on the target's stock.

The Fed also concluded that the nature of a junk bond-financed takeover through a shell company necessarily creates "practical limitations on disposition of the margin stock by the shell corporation" that make the loans "indirectly secured" within the meaning of Regulation G. A restriction on disposition of margin stock, even if it does not amount to a formal security interest, is a traditional form of indirect security under the margin rules. An example is a negative pledge (that is, a promise by the borrower not to sell or pledge the stock to someone else while the loan is outstanding).

In the shell company situation there is no written negative pledge. But, as the Fed said, it is "reasonable to assume that lenders would not extend credit to such a shell acquisition vehicle unless there were an understanding that it will hold the stock of a particular company." In the real world, investment bankers and takeover specialists would not risk their credibility (and their ability to raise the money to do the next deal) by violating that understanding, even if they had the legal right to do so. In the Mesa-Unocal situation, for example, the junk bond buyers certainly understood that Newco was not going to sell the Unocal stock and go into the oyster business.

A narrow application

The Fed went far out of its way to emphasize the narrow scope of its interpretation. It did so primarily by discussing situations in which the interpretation would not apply. These situations fall into two categories:

— Where the shell and target will merge; and

— Where an operating company issues or guarantees the junk bonds.

The merger exception is simply that, even if a shell company issues debt securities that would otherwise be subject to the margin rules, the margin requirements would not apply "if, at the time the financing is committed or, in any event before the loan funds are advanced, a merger agreement has been executed or the merger may be accomplished by operation of law." This exception flows out of the rationale of the interpretation itself. If it is certain that there will be an immediate merger of the shell and the target, then, as the Fed said, "it is reasonable to assume that purchasers of any debt securities issued by the shell corporation would be relying on the assets of the target company, not its stock, as the source of repayment for the credit."

The exception for situations in which there is a merger agreement means that the interpretation should not adversely affect friendly or negotiated transactions. The exception for situations in which a merger can be accomplished as a matter of law is a reference to so-called short-form mergers permitted under state law.

The Fed said that the statutory merger exception is available only where "the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without approval of the shareholders or directors of the target company." A short-form merger typically requires a very high proportion of the shares — 90 percent under Delaware law, for example — so the practical impact of this exception may be limited.

The second category of exception is where the junk bonds are issued or guaranteed "by an operating company with substantial assets or cash flow." This is the exception likely to generate the most interest and, ultimately, litigation in the future, because targets and acquirers can be expected to have sharply different notions of what "substantial" means.

In principle, one cannot argue against the conclusion that the interpretation should not apply where the issuer (or guarantor) of the debt has enough assets or cash flow to support the debt without regard to the margin stock. Regulation G itself provides that a loan will not be deemed indirectly secured where the lender in good faith does not rely on margin stock as collateral in extending the credit [Section 207.2(f)(2)(iv)]. This seems to imply that one would determine whether the issuer (or guarantor) has "substantial" assets and cash flow by comparing the amount of the debt to the size of the assets and cash flow of the borrower (or guarantor).

Some open issues

That conclusion may turn out to be correct, but it is hard to tell exactly how the Fed intends to analyze the issue. The only concrete evidence we have of the Fed's view is its statement that it "does not consider" the Pantry Pride-Revlon or GAF-Union Carbide financing arrangements "as falling within the presumption of indirect security contained in the interpretative rule adopted today." The Fed did not give the basis for that conclusion, other than to note that Pantry Pride and GAF were operating companies.

As reported by the Fed, Pantry Pride proposed to borrow more than $850 million at a time when it had assets of about $400 million and net worth of about $145 million. GAF, according to the Fed, proposed to borrow $2.3 billion at a time at which it had about $800 million in assets and stockholders' equity of $280 million. While the issue can be debated, the target companies in those situations certainly could make a case that the junk bond lenders must have been relying on the target's stock as collateral, because, while not shell companies, Pantry Pride and GAF were borrowing amounts far in excess of what their assets and business would justify absent the acquisition of the target's stock. We can expect to see an argument like this made by future targets.

Two other aspects of the interpretation are worth noting.

One concerns the so-called "public offering" exception to the margin rules. For reasons that are not entirely clear, but that apparently have to do with concern about practical problems in assuring compliance, the Fed staff had previously expressed the view that a public offering of debt securities is not an extension of credit within the meaning of the margin rules. The basis, scope, and purpose of this position were called into question in the Pantry Pride-Revlon transaction, where the junk bonds were registered with the Securities and Exchange Commission as if they were being publicly offered, but in fact were sold in minimum units of $2.5 million to institutional and sophisticated investors as in a private placement.

Public offering exemption

The Fed's original, December 6, 1985, proposal would have eliminated any distinction between private placements and public offerings for margin rule purposes. The final interpretation pulls back from that position, noting the possibility of "operational problems" if public offerings were subject to the margin rules. However, the Fed made clear that the exception exists only for "bona fide public offerings" and would not be available for what in substance are private placements (as in Pantry Pride-Revlon), even if, in form, they are public offerings.

The other matter of importance is the Fed's decision that the interpretation would not be retroactive, that is, it would "not apply to written contracts to extend credit entered into prior" to January 10, 1986. Obviously there is some tension between the Fed's view that it is simply stating an interpretation of what the margin rules have always meant (and not amending the rules, which would require a rulemaking under the Administrative Procedure Act), and its conclusion that the interpretation was new enough to make it prospective only.

As a practical matter, the Fed had little choice but to make the interpretation prospective. The validity of a number of transactions might otherwise be called into question, including transactions in which the staff confirmed that the margin rules did apply. By making the interpretation prospective, the Fed probably also reduced the likelihood of a lawsuit challenging its decision.

The interpretation will have less practical impact than the sound and light show that preceded its adoption might have led one to think.

The interpretation will prevent an acquirer from using a shell corporation to issue the junk bonds, as in the Mesa-Unocal transaction, unless it can come within the immediate merger exception. (To be technically correct, one would say that if the shell corporation issues the junk bonds, it will have to comply with the margin rules; that is, it could issue debt securities in an amount equal to no more than half the market value of the target stock it will buy.) This will certainly prevent the hardware store in Bethesda, Md., from making a run at Exxon Corp. by using junk bonds.

But its practical effect will be limited because acquiring companies will restructure their transactions so that the shell company will not itself issue the debt. This had already started to happen before the interpretation came out. The Pantry Pride-Revlon transaction is an example.

Of course, it will not always be possible for a parent company to issue or guarantee the junk bonds. There may be covenants in other debt instruments or bank loans, or objections from other creditors or joint ventures, in the way. Moreover, there is a real, not just a legal, difference between the parent issuing or guaranteeing the junk bonds and the shell alone issuing the bonds: The parent corporation takes on a substantial liability in the former situation that it does not have in the latter. This may make directors of public companies concerned about issuing or guaranteeing the bonds. Thus, restructuring to use the parents' credit standing may not always be an available option.

Issuance of junk bonds

But it may not be necessary to have the parent company itself issue or guarantee the junk bonds. For example, one would expect to see attempts by acquirers to have a subsidiary between the parent and the shell issue or guarantee the junk bonds. They will then argue that the intermediate subsidiary has "substantial" assets or cash flow and that the interpretation is not applicable.

If an acquirer sets up a new intermediate subsidiary and puts a few assets into it in an effort to avoid the interpretation, the target will have a good argument that the subsidiary does not have the "history of ongoing business operations" to which the Fed referred in explaining why debt issued or guaranteed by an operating company is not covered by the interpretation. But if the acquirer uses a pre-existing subsidiary with a small amount of ongoing operations, the issue will certainly be litigated.

There are several other restructuring avenues for an acquirer to consider. One is an increased use of preferred stock issued by the shell, rather than debt, to finance the takeover. Of course, the shell does not get the advantage of the interest deduction when it uses preferred stock, and this is a major consideration. But the junk bond buyers (assuming they are in corporate form) would get the benefit of the 85 percent dividend exclusion if they bought preferred stock, which should allow the shell to pay less in dividends. If preferred stock is used, the target could, depending on the terms (such as whether the preferred has a set term), argue that the preferred is really an extension of credit under the margin rules — though this would ordinarily be an uphill battle.

The Market for Junk Bonds

The market for junk bonds often is talked about but seldom defined. Indeed, to more orthodox investment segments, the junk bond market often seems to be a shadowy, obscure place with dim configurations. But it obviously exists, and it operates largely outside the public arena. Seldom is a junk bond issue sold and traded publicly.

However, junk bonds are getting a glimmer of public view through the creation of a series of mutual funds that are designed expressly to invest in high-yield debt securities. But public participation is limited, since the funds are sold largely to individuals of high net worth. These bonds usually are given C ratings — or highly speculative — by the securities rating agencies.

Other buyers include insurance companies, pension funds who have the authority to invest a small portion of their assets in high-yield securities, and private money pools. At one time, savings and loans were heavy buyers of junk bonds. But they have cut back sharply in recent years after the Federal Home Loan Bank Board expressed fears that the thrifts might be overcommitting themselves in speculative holdings.

M&A

Another possibility would be for an acquirer to take advantage of the public offering exception by issuing junk bonds in a registered public offering in the relatively small denominations that are typical of a bona fide public offering. This may be difficult to do during a hostile takeover, and so some companies may decide to raise money from the public in advance of their need for the funds — though complying with the SEC disclosure requirements could get tricky in this situation. An acquirer planning to take advantage of this exception may decide to do so soon, because the Fed indicated in its commentary that it may consider a formal amendment to the margin rules eliminating or modifying the public offering exception.

Signal from the Fed

In short, there are many ways to avoid the interpretation for those with resources and imagination — which is an apt description of most of the major potential acquirers. At the same time, the interpretation does provide a basis for target companies to argue to the Fed and in courts that the margin rules are applicable to the financing of a hostile transaction. And the Fed's action sends a signal to the markets and to the Congress that, at least as presently constituted (and by a one-vote margin), the Fed is concerned enough about junk bond-financed takeovers to take a modest step to limit their use. ■

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM LLOYD N. CUTLER

Q. 1. **Arguably, U.S. businesses are under leveraged when compared with businesses in Japan and West Germany. Given the problem of global competitiveness, why should we be overly concerned about our corporate debt in light of the usual corporate financial structures in two of the most competitive countries in the world? Doesn't proper leveraging allow for sustained growth and further job formation (among other things, cost of debt capital is less than the cost of equity capital?)**

A.1. As I have stated in my answer to Senator Proxmire's similar question, the higher debt-to-equity ratios of Japan and the Federal Republic of Germany are really not comparable. Most major Japanese industrial firms are linked together with other firms of the same group in a "tiger tail" relationship, in which the firms collectively own virtual control blocks of the shares of each of the related firms. The group usually includes a major bank which supplies dependable long-term financing at low interest rates through all phases of the business cycle and acts in the role of controlling shareholder to shake up management when necessary. In Germany the major banks own large equity holdings in the major industrial firms, sit on their supervisory boards and also provide dependable long-term financing at lower interest rates through all phases of the business cycle. Although the German and Japanese industrial firms are more highly leveraged than American firms, they are sheltered from takeovers and from the vagaries of the business cycle by low interest rates and by the all-weather financial support of the industrial or banking group to which they belong. The "tiger tail" in Japan and bank ownership in Germany also protects them from takeovers.

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D'Amato -- Cutler

Q. 2. **Senator Brady offered several recommendations in his proposal, as an attorney, do you think the legal framework regulating contests for corporate control would benefit from adopting some of his recommendations?**

A.2. I agree with a number of Senator Brady's proposals as well as those made by Martin Lipton. However, I would not favor disfranchising recently acquired stock because of the enormous practical complications that would be involved.

Q. 3. (A) **Do the securities and banking laws have to be amended to encourage the restoration of historic debt to equity ratios or should the tax code be changed to favor equity?**

(B) **When it becomes cheaper for a corporation to service debt instead of equity, wouldn't prudent managers opt for ahigher debt to equity mix?**

(C) **What is the debt/equity ratio of most Japanese companys? How can they maintain their stability and growth with such high debt to equity ratios.**

A.3. I believe the securities law should be amended as suggested by Martin Lipton. While the banking laws are very much out of date and require considerable revision, they do not affect debt-to-equity ratios. I do not think the tax code needs changing "to favor equity"; I do believe it needs changing so that it will stop favoring the creation of debt to retire equity as I suggested in my testimony.

A.3(b) Within the range of say 70% equity/30% debt to the reverse, perhaps so. To my mind it is never prudent for a manager to leverage himself down to 20% or 10% equity. In any event my proposals would not prevent managers from doing whatever they want. They would only apply the margin rules to takeover bidders and deny the interest deduction when borrowing to retire equity reaches imprudent limits.

A.3(c) See my answer to 1 above.

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D'Amato -- Cutler

Q. 4. On page 1 of your testimony you cite the fact that equity redemptions are exceeding new equity issues. What percentage of the negative swing of $100 billion is attributable to corporate takeovers?

A.4. I don't know. But if you include successful defenses against corporate takeovers, I would imagine the percentage is considerable. Junk bond issues in 1986 reached a level of $35 billion.

Q. 5. Your warning about the explosion of junk bond financed transactions appears to be a bit alarmist. A study prepared by the SEC's Office of the Chief Economist found that of all the 119 tender offers initiated during fiscal year 1985, only 12 proposed any financing using non-investment grade debt, commonly referred to as junk bonds. How do you reconcile this fact with the concerns raised in points four and five on page 2 of your statement?

A.5. Once again you are looking only at debt incurred by those opposing takeovers, not debt incurred by target corporations defending against takeover attempts or against the threat of takeover attempts that are never made because the defensive measures were taken.

Q. 6. We know national banks are restricted from purchasing junk bonds. Are there similar restrictions on:

a) state chartered savings and loans.
b) federal chartered savings and loans.
c) state chartered banks.
d) credit unions.
e) pension funds.

A.6. I don't know but if not, there should be.

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D'Amato -- Cutler

Q. 7. **The ratio between debt and the gross national product has remained approximately the same for the past 30 years. The ratio is no worse today than it was 10, 20 or 30 years ago. What evidence can you provide us that the increase in corporate debt is a problem today? Follow up: the bulk of our nation's debt is not corporate debt but the federal debt. All corporate debt, including high yield or non-investment rate debt is $475 billion dollars. The federal deficit is over $2 trillion. Doesn't this suggest that the rise in corporate debt is not the real problem?**

A.7. The problem about which I testified is not the ratio of all debt or corporate debt to GNP; it is the ratio of corporate debt to corporate equity. The ratio between all debt and GNP and between federal debt and GNP may well be serious problems in themselves as Henry Kaufman and others have warned us. But the dwindling equity of business corporations is also a serious problem itself.

Q. 8. **The equity to debt figures which you refer to in your written statement -- aren't they book value figures? Are you aware of the equity to debt market value figure for 1983 to 1986? If not, could you provide them for the record?**

A.8. Of course they are book value figures, but book value is what counts. When a corporation's cash flow cannot service its debts, the market value of its stock will rapidly go down to book value or less.

Q. 9. **In general, what effects does inflation have on the difference between market value and book value of assets?**

A.9. It depends on the industry. The market value of an oxygen furnace or a continuous strip mill in the United States is probably well below book. Moreover, if we achieve 10 years of low inflation, there will be little difference between book (plus accrued depreciation) and replacement values.

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D'Amato -- Cutler

Q. 10. In general, what effects does inflation have on the difference between market value and book value of liabilities?

A.10. Again it depends on the particular liability. The market values of bonds and other long term debt are sensitive to changes in interest rates and credit ratings that may or may not have inflationary causes.

Q. 11. In general, what bias would you expect from equity to debt ratios computed over long periods of time without adjusting the figure for the effects of inflation?

A.11. Little if any. Equity-debt ratios remained relatively constant during the inflationary cycle of the 1970's.

Q. 12. What is the real economic effect on equity to debt ratios when the dow industrial average goes from 900 to 2100? In computing equity to debt ratios based on market value, is this more or less significant than a 10 percent book value decline?

A.12. One might ask the reverse question. What if the Dow goes back from 2100 to 900? How many banks (or bond buyers) would lend money to a corporation on the security of its own stock? And how many LBO companies are now selling stock with the Dow over 2000 to retire the debt they incurred to retire stock over the past three years? Why is net equity redemption still running at such high negative rates?

Q. 13. If you were a corporate treasurer in 1984, and your company's growth for 1985 was going to require external financing -- what items would you look for in choosing between issuing equity or floating debt? Is equity always better than debt? Would you just look at your debt to equity ratio? Or wouldn't you also look at the level of interest rates compared with a required dividend payout ratio, whether or not there would be negative or positive dilution in your stock prices? The company's effective tax rate and its need for further shelters? Projections of other debt or equity issuance in the year? And a host of other factors?

A.13. I would look at all the factors you mention. But no one moves to 10 or 20% equity to finance internal growth. They do it to buy and recapitalize other companies, or to defend themselves against a leveraged takeover.

Q. 14. When a company issues debt to buy back its stock what is it saying about its own view of the company or its view of the market and its evaluation of the company?

A.14. It is saying primarily that it is foregoing internal growth to defend itself against a leveraged takeover. Look at Phillips, Unocal, CBS, Owens-Corning.

Q. 15. The 1985 Annual Report of The Council of Economic Advisers states, "the best assurance an incumbent management has against a successful takeover attempt is a stock price that is high relative to outsiders' estimates of the potential value of the corporation's shares. Managements that allocate capital to higher valued uses, operate efficiently, and adopt capitalization structures responsive to prevailing financial market conditions are less likely to be subject to takeovers than other management groups. Consequently, in order to prevail in the external market for corporate control, it is not enough that an incumbent management believes that it is doing a proper job, or that it persuades stockholders that it is doing so. Instead, management must demonstrate that its performance is competitive with the performance of other potential managers, and the value of management's performance must be reflected in the corporation's stock price. In this fashion, the external market for corporate control disciplines managers who believe they have maximized the value of the corporation's shares when, in fact, they have not."

What is your response to the argument expresed here that if target companies had been managed to maximize shareholder wealth they would not have ended up as "targets"?

A.15. I have no quarrel with the existence of an external market for corporate control. My quarrel is with our failure to use the margin rules and tax laws as disincentives to excessive over-leveraging, which in my view has harmful macro-economic effects that outweigh the benefits of shaking up entrenched managements.

Q. 16. The 1985 Annual Report of The Council of Economic Advisers states

> "to the extent that government regulations impose costs on bidders, or reduce a bidder's chances for success, fewer takeover attempts will be made. This tends to insulate corporate managements from the competitive pressures of the external market for corporate control. Stockholders as a group will also suffer as a result of excessive regulation because it reduces the chance to earn takeover premiums."

How do you refute this argument?

A.16. Same answer.

Q. 17. What is your response to the following statement which appeared in the 1985 Annual Report of The Council of Economic Advisors?

> ". . . The current state of knowledge strongly indicates that further federal regulation of the takeover process, particularly insofar as it would make takeovers more costly, would be poor economic policy."

A.17. I disagree. A similar point could have been made to oppose the 1933 Securities Act and the 1934 Exchange Act.

Q. 18. The 1985 Annual Report of The Council of Economic Advisors states:

> "the available evidence, however, is that mergers and acquisitions increase national wealth. They improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management. They also help recapitalize firms so that their financial structures are more in line with prevailing market conditions. In addition, there is no evidence that mergers and acquisitions have, on any systematic basis, caused anticompetitive price increases."

The report goes on to state:

> ". . . There is no economic basis for regulations that would further restrict the merger and acquisition process."

A.18. If prevailing market conditions encourage LBO's with 10 to 20% remaining equity, I believe the government has a duty to regulate the market. One might as well argue that the "market forces" that created outlaw behavior on the American frontier helped to keep other settlers on their toes and stimulated economic growth.

Q. 19. Given the fact that mergers and acquisitions taken in the aggregate are beneficial to society and the economy would you propose somehow to distinguish between "good" and "bad" acquisitions?

A.19. No. The antitrust laws are adequate for that purpose. But I would distinguish between "good" and "bad" equity/debt ratios, at least in our margin and tax rules.

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D'Amato -- Cutler

Q. 20. The 1985 Annual Report of The Council of Economic Advisers states:

> "the evidence also suggests that abusive practices in the market for corporate control are limited largely to tactics employed by target managements who, in opposing takeover bids, defeat or deter tender offers at the expense of their stockholders and the economy."

How do you defend the defensive actions of management and should legislation be introduced to eliminate these types of abuses?

A.20. The Lipton and Brady proposals would regulate both sides. I support this sort of even handed approach. The CEA would undoubtedly wish to modify its "limited largely" language after studying the abusive offensive practices disclosed in 1986 and 1987.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM RODERICK M. HILLS

Q.1. You state on page one of your testimony that the destructive effects of today's hostile takeovers "seem to be more evident than its creative values" and then on page four you note certain aspects of such takeovers that cause you concern. Among these are your contention that "attention must be paid to parallel accumulation of stock by arbitrageurs, their associates and foreign investors who have some reason to believe that a takeover is in the works. The Guinness scandal in England and stories about how Mr. Boesky operated suggest that this "technique" may be used too often."

Can you explain to us what you mean by "technique" in this context? Can you also give your views on whether there is or might be an illicit relationship between investment bankers, arbitrageurs, raiders and purchasers of junk bonds in terms of putting a company into play?

A. 1. A large number of fund managers engage in "risk arbitrage." An essential feature of that business is to buy stock in companies that the fund manager believes will be sold or bought in the not too distant future. The basis for that "belief" could be:

- Research work that shows a stock to be undervalued.
- Knowledge that similar companies are being bought; e.g., when Dean Witter and Bache Securities were sold in 1981, many funds bought a lot of E.F. Hutton stock believing that it might be sold.
- Knowledge that "someone" has bought 5% of the stock of a company and may buy more; i.e., the company is "put into play."

In any of these circumstances, an arbitrager or any fund manager will try to find out what other investors are doing. At any given time, a large number of such managers will know that there are 20 to 50 companies "in play"; i.e., that a lot of the stock is owned by short-term investors that are waiting for someone to tender for all the stock of any one of these companies. Each of these managers will own less than 5% of the company's outstanding stock, but the group of them will have a very large amount. Normally, it would be incorrect to say that they are acting in concert. Rather, they simply know the likelihood that all will sell at certain prices.

This "parallel accumulation" sets a company up (puts it into play). Anyone who wishes to make a tender offer for such a company "knows" that a substantial amount of the stock is being held precisely for the purpose of tendering for a proper bid. Moreover, information in the arbitrage community is such that it is possible to "figure" the price at which the stock would in fact be tendered.

There may well be an "illicit" sharing of information in some of these cases. However, it is hard to say what is and what is not illicit. "Conscious parallelism" in collecting stock is probably not illicit, although a planned joint effort would be illicit.

As I stated in my prepared remarks, the potential for "illicit" conduct would be greatly reduced if disclosure of holdings were required at a lower level than 5% when the holder has good reason to believe that the same stock has been accumulated by others in anticipation of the sale of the company.

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Proxmire--Hills

Q.2. Please list and clarify exactly what abuses you believe are occuring in the conduct of hostile takeovers.

A. 2. Essays can and have been written about what is and what is not an abuse "in the conduct of hostile takeovers." Any given technique, whether a "two-tier offer" or a "poison pill" may or may not be abusive, depending upon how it is employed. For that reason, I believe it to be counterproductive to attempt to legislate rules separating good from bad techniques. Simply stated, it is "bad" for a board to frustrate a bid to preserve management when it is apparent that a fair bid provides a chance for all stockholders to realize far greater values than can be reasonably be expected by "holding the stock." Similarly, it is "good" for a board to stop a bid when it is designed to elicit "Greenmail," when the bidder's crash techniques threaten to saddle a major percentage of stockholders with paper of a questionable value, or where the director believes that they can save values for stockholders if given a reasonable period of time. For example, faced with a hostile takeover, directors may wish to have time to arrange a leveraged buyout or a different sale that would provide greater values to the stockholders.

In short, I firmly believe that the only feasible solution to abuses by either the bidder or the seller is to make independent directors fully aware of their fiduciary obligation to shareholders.

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Proxmire--Hills from the ECONOMIST, February 7-13, 1987

Rules for the City

The Guinness affair shows the need for tougher sleuths, not new laws

The scandal surrounding Guinness's takeover of Distillers in early 1986 has produced a great froth about how to police the City of London. Some say that the Guinness affair proves self-regulation does not work, so Britain needs the equivalent of America's statutory Securities and Exchange Commission (SEC). Others say such a change would destroy the City's flexibility. Both views exaggerate. Britain's new policing system is not just self-regulation, and Britain already has an SEC. The real questions are whether it is powerful enough, and whether it is responsible for the right things.

The Guinness case reveals nothing, directly, about the new system of regulation. The takeover took place under the old system, before Big Bang detonated and while the Financial Services Act was still a messy draft. It has made a nonsense of City folks' warnings that letting foreigners into the City would cause dirty deeds. The Guinness affair involved the best British merchant banks, stockbrokers and managers. The maggots were in the City's own apples.

The case exposed no glaring inadequacies in the law: the Department of Trade and Industry's (DTI) investigation concerns possible breaches of the Companies Act, an existing and powerful piece of legislation. Two blind spots were exposed, however: the ability of investors to disguise themselves through nominee accounts; and the fact that shareholdings do not have to be disclosed until they reach 5%. This second spot has now been cleared up by the Takeover Panel, though only within its non-binding set of rules.

A bigger SIB

What the Guinness affair does confirm is the difficulty of discovering when the law has been breached, and then bringing the breachers to book. It exposes the impotence of the Takeover Panel, a voluntary body that rules on bids. The panel did not see what was going on during the Guinness bid, and probably during other takeovers. Its failing was not unique: regulators, including America's SEC, often miss misdeeds. But the panel is an unsatisfactory hybrid, needing stronger powers and a clearer purpose. It would get both by becoming part of the SIB.

Even without such a change, the differences between Britain's new regulatory system and America's longstanding one are far less than most people suppose. Each is a blend of statute and self-regulation. Yes, the SEC is a statutory body. So will be the Securities and Investments Board (SIB) when it gets into full operation next autumn. It will be independent of, but with powers granted from, the department of trade.

The SEC has powers to subpoena witnesses for information and to investigate when and whom it wishes. So do the SIB and the DTI. Like the SEC, the SIB has the power to initiate prosecutions. Under the SIB's gaze, but at one remove from the law, Britain has an array of "self-regulatory organisations", such as the International Stock Exchange (*né* London Stock Exchange), to draw up rules and monitor investment firms. So does the SEC. One American self-regulatory organisation is called the New York Stock Exchange; it performs most of the task of using computers to identify fishy transactions (see page 74).

It is therefore not necessary to give Britain an SEC. That does not mean that no changes are needed. Although the SIB has statutory powers, it has real weaknesses. It will spend most of its time overseeing a system that is probably too complicated, rather than rooting out abuses of it. Worse, the SIB is not responsible for policing the two headline-grabbing areas of misbehaviour—insider trading and takeovers. Insider-trading cases are handled by the DTI. The Takeover Panel is outside the SIB's control. Prospectuses and other company information are filed with the Stock Exchange and the trade department. In America, all these powers and responsibilities lie with the SEC.

The case for having three separate City regulators is weak. Now that City gents no longer act like gentlemen, the Takeover Panel's rules need statutory force if they are to be obeyed. Most insider-trading cases are related to takeovers, so it would be neater to handle investigations into both within the same body. Securities crime cannot be eliminated; the task is to deter it, and to make detection as likely as possible. This task would be made easier if the trade department's and the panel's responsibilities were consolidated into the SIB.

Securities sleuths are more likely to track down criminals if they are rewarded for success in some way. America's SEC gets good, eager young lawyers because a reputation built at the commission helps their careers later. But it has to pay civil-service rates, so its staff turnover is high. The DTI suffers from the same weakness. The SIB is better placed, because it can pay market rates. To build a crack squad of investigators, however, it will need much more than the £7½m ($11.5m) budgeted for its first year, and more staff than the 80 it has now. It will not need to match the SEC's 2,080 staff and $115m annual budget because it is dealing with smaller financial markets. At a guess, it might need £20m a year—probably too much to raise through the present levy on City firms. Public money will therefore be needed, as a top-up. If the Treasury protests, it should be reminded that £20m is less than the advertising budget for the flotation of British Gas.

from the WALL STREET JOURNAL, February 8, 1987

How to Avoid Conflicts of Interest in the Takeover Game

Manager's Journal

By Ben W. Heineman

Directors trying to make astute buy or ell decisions during corporate takeover attles are often obstructed by strong con-icts of interest involving the management nd professional advisers. The conflicts re-ect two competing trends: the tendency n takeovers for directors to affirm the hief executive officer's policy decision ather than to initiate policy themselves, nd the directors' recognition that the hief executive and his close management ssociates may have personal motives anging from protecting their tenures to etting up "golden parachutes" in case ney have to bail out.

Any meaningful takeover threat and its yzantine consequences ultimately involve uestions of value, and fairness to the ockholders. The key professionals are in-estment bankers and special takeover wyers. Their interests and the goals of e officers who engage them may be osely allied and may conflict with the rceived interests of the directors and ockholders.

The investment banker's function is to ve a reliable opinion on value and fair-ss. Nevertheless, the banker frequently s a conflict of interest that, if faced by a rector, would prevent the director from rticipating in any way in the takeover cision and could compel his resignation. e conflict arises from the millions of dollars of fees contingent upon the completion of the transaction, and if the transaction succeeds from the expressed or implied promise of major future transactions. One could reasonably believe that the potential benefits of the transaction to the investment-banking firm might undermine the detachment and independence of its opinion. Fees in excess of $20 million are not unknown.

Not just years or decades, but centuries of experience have taught us that those with a conflict of interest cannot effectively and fairly represent others. John Alden was not the proper representative for Miles Standish.

What to do?

Investment bankers should remember the history of contingent fees in acquisitions and divestitures. When ongoing relationships rather than individual transactions were the foundation of investment banking, modest contingent fees were designed for the protection of clients and to enhance the relationship between client and banker. The size of an individual transaction was small when compared with the value of the longstanding relationship. The transaction seldom involved the tenure and, hence, the personal self-interest of the chief executive. Today, transactions, and not relationships, are the foundation of investment banking; the value of most traditional corporate relationships pales in contrast to the benefits of a single transaction.

A recent Wall Street Journal story discussed the contingent or "performance" fee of millions of dollars charged by a leading takeover law firm in a major transaction. The fee would be paid only if the transaction took place. The chief executive of the acquiring company is quoted as saying that the lawyers "did contribute much" to the pursuit of the target, and that what they do "goes much beyond legal work."

Performance fees for corporate lawyers are too recent an innovation to know whether the concept will spread. I would hope that performance fees would die aborning so that directors could be assured of dispassionate and independent advice from their counsel.

Corporate boards should acknowledge the conflicts of interest of their professional advisers and take steps to reform these relationships. As a matter of internal control, these steps should include giving unmistakable policy guidance to the chief executive. The normal deference given by a board to a chief executive functioning in the usual course of business has no application to such extraordinary policy issues as the purchase of a major enterprise in an unfriendly takeover or the sale of the entire business.

When faced with such situations—with the powerful, and perhaps overriding, conflicts of interest of the lawyers, investment bankers and even management—the directors' alternatives are difficult but clear: The directors may oppose the transaction as a matter of principle on the ground that the board's professional advisers are as disqualified from participation as the directors themselves would be; they may vote for the transaction with the nagging fear that the professionals' opinions have been unduly influenced by the huge contingent fees and other perquisites; or, they may seek to retain yet more investment bankers and lawyers to review—exclusively on behalf of the board—the professional opinions that the corporation already has obtained.

In one widely noted case, "outside" directors at Owens-Illinois chose the latter route, retaining additional investment bankers and lawyers unrelated to the company or its management. The bankers chosen by the directors reached different conclusions from those of the bankers selected by management. Each set agreed with the objectives of its patrons, although each was representing not its patrons but the corporation and its stockholders.

I would urge all those concerned in a takeover to reexamine their corporate relationships with utmost care. It is only a matter of time before a dramatic economic downturn, or some other drastic event, will bring a sea change in current mores. This will call into question many of the transactions that will have taken place, including many that will have seemed secure. The result could easily be external intervention, investigation and regulation, accompanied at the very least by extreme embarrassment to many prominent but shortsighted people.

Whatever their reasons, in initially opposing management and its professionals and following their own independent views, the outside directors of Owens-Illinois have increased the value of the company for the shareholders by at least $180 million.

Mr. Heineman was founder, chairman and CEO of Northwest Industries, a Fortune 500 company, until 1985.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

RODERICK M. HILLS

Q. 1. **You mention the need to reform the ways hostile raids are launched and fought. However, won't legislation aimed at impeding hostile raids also adversely affect friendly offers and leveraged buy-outs?**

A. 1. The only legislation that I would support now would be to reduce the notice period under the Williams Act to one day and to require disclosure of ownership when it exceeds 2% of outstanding stock when the owner has knowledge of "parallel accumulation" of the same stock. Neither would adversely affect friendly offers or leveraged buy-outs in my opinion. If at some future date, it becomes appropriate to make the presence and responsibility of independent directors more clearly subject to a federal standard, such a law would not adversely affect friendly takeovers or leveraged buy-outs.

Q. 2. **What percentage of all corporate takeovers that have been successful in the last 5 years have been hostile takeovers?**

A. 2. I do not know.

Q. 3. **Isn't the disenfranchisement of corporate shareholders through the elimination of the one share/one vote rule the ultimate form of management entrenchment? Wouldn't someone who wanted control of a company purchase the voting stock and ignore the other shareholders? In a scenario where a shareholder vote was required to approve a hostile offer or a leveraged buy-out, would all shareholders have a right to vote on a one share/one vote basis or should disparate voting rights be recognized in this situation as well?**

A. 3. Yes. I do not favor legislation mandating one-share/one vote. However, any legislation would have to accommodate disparate voting rights where they were created for good economic reasons.

Q. 4. **What was your justification for voting for the poison pills in the two cases you mentioned in your testimony. In both cases, what was the effect of voting for these poison pills on the price of the target company's stock? Did the shareholders have any voice before you voted to adopt a "poison pill" and if they didn't should they have had some say?**

A. 4. In the two cases in which I voted for the "poison pill," I did so to reserve some discretion in the independent directors to act in the best interests of shareholders. I believe that the exercise of that discretion must be done strictly for the best interests of the shareholders. I very much feel that my decision in any such case could subject me to personal liability. I see considerable merit in having stockholders ratify the adoption of a "poison pill" defense at the earliest next shareholders meeting. If legislation were introduced on this subject, I believe it should be more comprehensive than "poison pill" legislation. It should in effect give independent directors considerable discretion to turn down an offer, but at the same time subject them to liability if they acted against the best interests of shareholders. I would not favor such legislation now.

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Q. 5. **On page 8 of your testimony you state that "a standard of director responsibility is evolving out of practice . . ." Are you suggesting that we in essence pass a law that federalizes the business judgment rule? What would be the benefits and shortcomings of such a proposal?**

A. 5. I believe there is, in effect, a federal standard now and I believe the SEC could bring some landmark cases against independent directors who fail to appreciate their responsibilities as members of an audit committee that must monitor the audit and disclosure practices of a publicly traded company. If this litigation I suggest is inconclusive, I believe it proper that a federal standard be imposed. Some attention could also be paid to the current ALI effort to restate director's responsibility. It appears that its original misguided effort to prescribe rules about director's responsibility is now better directed to the recognition that directors to have a more profound responsibility to shareholders than many now seem to appreciate. Also, as I suggested in my prepared remarks, the auditing profession could refuse to accept auditing responsibility for any publicly traded firm that does not have a sufficiently independent audit committee.

Q. 6. **You state on page 9 that "dividends can be suspended if corporate plans go awry. Only bankruptcy can relieve a company of its duty to pay interest." Isn't this statement a bit alarmist because a company can, and often does, restructure its debt as a method of avoiding bankruptcy? Doesn't this also say something about your attitude toward shareholders -- when a company's plan goes awry they should be expected to sacrifice their dividends and the incumbent managers sacrifice nothing. Doesn't the threat of a hostile offer have the effect of ensuring that management is not so willing to sacrifice the benefits shareholders expect to receive? After all, aren't satisfied shareholders the best defense against a hostile offer?**

A. 6. My only attitude toward shareholders is that they are investing risk capital and risk capital is more conducive to growth and innovation than debt capital. I fully agree that the threat of a hostile takeover is an incentive for the kind of good management that will best benefit shareholders.

Q. 7. **In essence aren't you saying that hostile corporate takeovers are a symptom and not the cause of a greater problem and to get at the symptom you must find a cure for the cause. For example, the cause of hostile offers is the inequitable tax treatment of debt and equity. If we cure the cause, then the symptom will disappear?**

A. 7. I agree entirely with your observation.

Q. 8. **What do you believe to be the causes of hostile corporate takeovers other than the inequitable tax treatment of debt and equity?**

A. 8. Our tax treatment of capital gains and our failure to have better incentives for saving contribute to the undervaluation of equity capital. Also, a higher savings rate in the United States would necessarily provide a bigger pool of capital for investors in equity.

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D'Amato--Hills

Q. 9. **Do you believe that the payment of greenmail to a potentially hostile raider is preferable to the initiation of a hostile takeover?**

A. 9. No. Generally speaking, "Greenmail" is an undesirable tactic.

Q. 10. **Would the shareholders of the company paying greenmail benefit more from the elimination of a potential hostile raider than from the execution of a successful hostile takeover initiated by a bidder?**

A. 10. Shareholders will seldom benefit from the payment of Greenmail. I can, however, conceive of rare instances where the harassment of a takeover threat can be unfairly harmful to stockholders. For example, a takeover threat that has no propsect of a 100% payment above market price to all shareholders can damage the company. Thus, I would in rare cases permit an independent director to authorize a Greenmail-type act where they could demonstrate that it was, in fact, in the best interests of stockholders.

Q. 11. **In September 1984, the SEC released a study concluding that greenmail payments adversely affect the shareholders of the greenmailed company. The report stated:**

> **"The evidence suggests that non-participating shareholders suffer substantial and statistically significant share price declines upon the announcement of targeted repurchases at premiums above market value. The overall impact on share prices from the date the initial foothold position is established to the date the block is repurchased is also negative . . . We conclude that the overall impact of targeted share repurchases on the wealth of non-participating target shareholders is negative. The stock price evidence indicates that the magnitude of the losses to non-participating target shareholders is at least equal to the wealth loss implied by the cash premium paid for the block purchase."**

A. **Do you agree with the SEC's conclusions?**

B. **Do you believe that legislation is required to restrict or prohibit the payment of greenmail?**

A. 11. A. I generally agree with this conclusion.

B. No. I would rely on the discretion and responsibility of independent directors in the manner set forth above and in my prepared testimony.

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Q. 12. **The study of what modifications to the Williams Act are required is not a new subject before the Committee. Past experience has demonstrated that any attempt to restrict or prohibit "hostile offers" has an unintended negative impact on friendly takeovers and leveraged buy-outs. Therefore, the task before this Committee is to identify those abusive practices that are attendant to all corporate takeovers, especially hostile takeovers, and restrict these practices in a manner consistent with the original purposes of the Williams Act.**

A. Our inquiry should begin with an identification of those practices which you consider to be abusive?

B. Which of these abusive tactics do you consider to benefit the target and which do you consider to benefit the bidder?

C. Implicit in your criticism of the present regulation of the market for corporate control is that the williams act is inadequte. What has changed since the 1968 Act that enables you to state the Williams Act is no longer working? What changes do you recommend? Must all of these changes be accomplished through legislation?

A. 12. My comments are directed toward part C of your question. Since 1968, block trading is far greater. Also, we have developed hedging techniques with options and other devices that have made the market far more efficient. Thus, fund managers can move far more capital far faster than in 1968. My earlier comments about parallel accumulation of stock seem to me to be adequate to the problem. Perhaps the SEC could effect the needed changes. As I tstified, I believe the effort should be neutral and should not benefit the "hunted" or the "hunter." I am not sufficiently informed to know whether legislation is needed. I do believe the Committee could secure a proposal from the Commission and then decide whether more specific legislation is needed.

Q. 13. Many hostile takeovers, leverage buy-outs and friendly takeovers have been partial or two-tier offers.

A. Has the frequency of partial or two-tier offers increased since 1984?

B. What are the benefits that shareholders realize from these offers?

C. What are the problems attendant to thse offers?

D. Are you aware that SEC studies demonstrate that shareholders receive a higher premium in two-tier offers than they do in any and all or partial tender offers?

E. Do you know what percentage of two-tier offers are negotiated offers and which are hostile?

F. Would you be surprised to learn that statistics compiled by the SEC for the years 1981-1984 demonstrate that virtually all (35 of 38) of successful two-tier offers were not hostile? Therefore only 3 of the 38 two-tier offers were hostile?

G. Do two-tier offers have a different impact on a surviving entities debt to equity ratios than successful any-or-all tender offers, partial tender offers, friendly offers or leveraged buy-outs?

H. Should we consider any legislation that restricts the use of two tier offers?

A. 13. A. I do not believe they have.

B. I believe the SEC studies demonstrate that two-tier offers are beneficial in most cases for shareholders.

C. I have nothing to add to the material now before the Committee.

D. Yes.

E. I accept the statistics referred to in F.

F. No, I am not surprised.

G. No.

H. No.

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D'Amato--Hills

Q. 14. A. Is the incidence of insider trading more prevalent during friendly or hostile transactions?

B. Should we curb all takeover activity to stop or curtail insider trading?

C. Recent SEC data demonstrate that insider trading is more prevalent in friendly rather than hostile transactions. Can you provide this tendency? Isn't the reason due to the fact that more people are involved in the execution of a friendly rather than a hostile transaction?

A. 14. A. I accept the SEC data referred to in C.

B. You should not "curb" takeover activity except to the degree that I would clarify the authority and responsibilities of independent directors. I see no need for further legislation with respect to insider trading. I would consider greater funds to the SEC to push them to try more and settle fewer cases.

C. I agree with your observation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
A. A. SOMMER, Jr.

Q.1. Your testimony seems to place much of the responsibility for takeover activity on the very short-term outlook of institutional investors. Their need for improved performance on a quarterly basis makes them extremely responsive to arbitrageur tender offers. By implication, lengthening the outlook of institutional investors would slow takeover activity. What could Congress do to lengthen institutional investor outlooks?

ANSWER TO Q. 1. With regard to what Congress might do to lengthen the investment perspective of institutional investors, I would venture the following suggestion. Many of the institutional investors enjoy tax benefits of one sort or another, e.g., pension trusts receive income tax free (hence they pay no capital gains tax with regard to their profits), charitable endowments and foundations, including those of educational institutions, are also tax free, and in a number of other instances Congress has seen fit, for one policy reason or another, to bestow upon institutions a preferred tax status.

If Congress concludes that indeed it is desirable as a matter of national policy that institutional investors have a greater long-term perspective, then I would suggest that institutions that enjoy a preferred tax status lose that tax status with regard to any gains realized from investments held for less than, say, a year (a longer or shorter period might be appropriate, but a year suggests itself as a logical period). Thus, if an institution wished to avail itself of short-term profit opportunities, it would have to suffer the detriment of having the gains from them taxed.

You are no doubt aware of the suggestion by Mr. Warren Buffett in the Washington Post recently suggesting that anyone selling a security in less than a year be subjected to a 100% tax on his profits; this would presumably apply to anyone, institution or individual. I think this is a somewhat draconian measure and is perhaps more than the situation necessitates.

Q.2. Please list and clarify exactly what abuses you believe are occuring in the conduct of hostile takeovers.

ANSWER TO Q.2. Second. With regard to the abuses which I think are occurring in connection with tender offers, I would list the following:

1. The accumulation of substantial amounts of stock in the market before disclosure is required. I have noted with interest that apparently the Panel on Take-Overs and Mergers in Great Britain proposes to modify its rules to require disclosure after as little as 1% has been accumulated by a would-be tender offeror. I would favor a change in the present law that would require disclosure when a would-be tender offeror has accumulated

as little as, say, 2%, and I would require that this disclosure be made within twenty-four hours after reaching the threshold. I would further suggest suspending further acquisitions for 48 hours thereafter while the information is disseminated. Furthermore, if anyone filed a Form 13D and stated that his purpose in making the acquisition was "investment," and thereafter he undertook any act looking toward a tender offer, I would place the burden upon the one filing to prove that his intent at the time of the filing was indeed one of investment, and failing to carry the burden, I would disenfranchise the shares, at least in his hands, for a period of one year.

2. The excessive leveraging of takeovers, both friendly and hostile. Nothing suggests to me that traditional standards with regard to the relationship between debt and equity have been obsoleted. If, as many commentators suggest, a sharp rise in interest rates (certainly a danger in view of our increasing dependence upon foreign investors to fund our national debt) or a severe recession (again a not improbable scenario), it is not unlikely that many of the heavily leveraged enterprises emanating from leveraged buyouts and takeovers will founder. If this occurs on a widespread scale, it may have damaging effects upon the economy and upon the attitude of Americans toward the economy and toward enterprise. Dealing effectively with this phenomenon is difficult. In lieu of a solution to the problem of excessive debt, it would be advisable at least to require that before commencing a bid an offeror be required to have firm commitment financing in hand. This would eliminate the present practice of huge bids going forward on the basis of "highly confident" letters from investment bankers.

3. The tactics used by Campeau in achieving its acquisition of Allied Stores - so-called "sweeping the street. In this tactic, a tender offer is terminated without purchasing tendered shares and then immediately thereafter enough shares are purchased from arbitragers and other large speculators to secure control. This practice could be eliminated by prohibiting the purchase or more than a specified percentage of shares (say, 10%) following an aborted tender offer for a significant period, say, six months.

4. Two-tier tender offers. While these are less frequent than they once were, their potential reappearance justifies legislative concern. These could be eliminated by requiring that if an acquirer wishes to acquire more than a specified amount of stock of a corporation, such acquisition must be made by tender offer for all outstanding stock of the class. In England, such a requirement occurs when the acquirer wishes to acquire more than thirty percent.

5. Too short a period during which a tender offer must remain open. At present a tender offer must be open for only twenty business days. Desirably a longer period should be required to provide more time for other offers to be developed and for analysis of the offer made, and to eliminate the haste presently attending the tender offer process.

6. Tender offers commenced without firm financing commitments in hand. In many instances tender offers are commenced on the basis of a so-called "highly confident" letter from an investment banker. The use of such letters in lieu of financing makes it possible for bidders to achieve a credibility they do not deserve and facilitates the use of bids for the purpose of simply putting a company "in play" or securing greenmail.

The foregoing is not intended to be a definitive list of abuses associated with tender offers and it is not intended to catalog the only means of coming to grips with these abuses. Other equally, or perhaps more, effective means may be available. All means of reaching the desired goal of rationally structuring the way in which hostile tender offers are accomplished should be explored.

Respectfully submitted,

A. A. Sommer, Jr.

AAS/mbl

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
A.A. SOMMER, Jr.

Q. 1. **In his testimony, Senator Brady makes seven legislative recommendations. Do you think that his legislative recommendations adequately address the abuses in the market for corporate control or do you think more drastic legislation is required?**

Answer to Q.1. **With respect to Senator Brady's suggestions in his tesitmony for legislation, while I agree for the most part with him, I do depart in some particulars:**

i. I agree that the SEC's ability to police insider trading should be strengthened. The Commission's proposed 1988 budget should enhance the Commission's policing capacities significantly.

ii. I am less sure than Senator Brady that a statutory clarification of the meaning of "insider trading" is necessary. Past efforts to develop such a definition have foundered because of the inability of interested parties to agree on an appropriate definition. Further, notwithstanding some unfortunate Supreme Court decisions, the Commission and the Department of Justice have not been handicapped in pursuing wrongdoers. However, if the Supreme Court's decision in the pending Winans case appears to hamper the Commission's enforcement abilities, then I would strongly advocate a further effort to clarify the meaning of "insider trading" through statutory definition.

iii. I believe the so-called "13(d) window" should be closed. I would, however, recommend a more stringent approach than that recommended by Senator Brady. I believe the reporting threshold should be 1 or 2% of a class outstanding and, as Senator Brady suggests, such an accumulation should be required to be reported within twenty-four hours. Moreover, I think such an acquirer should be precluded from further purchases for forty-eight hours after reporting.

iv. I agree with Senator Brady's suggestion for controlling "creeping" tender offers.

v. I believe "greenmail" should in some manner be controlled, but only if adequate measures are taken to eliminate the abuses associated with the conduct of offerors. If such measures are taken, then rather than the approach suggested by Senator Brady, I would suggest that the payment of "greenmail" (properly defined) should only be permitted if approved by shareholders.

vi. I agree with Senator Brady that measures should be taken to lessen the impact of the practice known as "sweeping the street." However, I would bar someone who has terminated a tender offer from purchasing more than a specified percentage of the stock of the issuer (say 10%) for a period of six months following the termination of the tender offer.

vii. I agree with Senator Brady that the inconsistencies between the Williams Act and the Hart-Scott-Rodino Act should be eliminated and that the present "loophole" in the latter statute permitting accumulations by partnerships without submitting filings to the Department of Justice and the Federal Trade Commission should be eliminated.

Q. 2. Mr. Hills suggests that a federal law be enacted which restricts a corporation's ability to change its state of incorporation. Do you believe such a law would be an unwelcome intrusion of federal law into an area of corporate governance traditionally left to the states?

Answer to Q.2. I do not agree with Mr. Hills that corporations should be prevented by federal law from changing their state of incorporation.

Q. 3. In his testimony this morning, Felix Rohatyn suggested that any legislative reform we consider include the re-establishment of the principle of one share/one vote. Do you agree or disagree with Mr. Rohatyn?

Answer to Q. 3. I disagree with Mr. Rohatyn's suggestion that any legislation adopted with respect to tender offers include a prohibition against classes of common stock having different voting rights. Historically the capitalization of corporations has been a matter of state regulation, which has afforded the shareholders of corporations broad latitude in choosing the configurations of voting and other rights which best suited the situations of their enterprises. I see no reason to interfere with this arrangement. Moreover, any change in shareholders' rights must be approved by the shareholders; it is difficult for me to understand why shareholders should be denied the right to vote for the capital structure they want in the name of protecting their voting rights.

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Q. 4. The study of what modifications to the Williams Act are required is not a new subject before the committee. Past experience has demonstrated that any attempt to restrict or prohibit "hostile offers" has an unintended negative impact on friendly takeovers and leveragec buy-outs. Therefore, the task before this Committee is to identify those abusive practices that are attendant to all corporate takeovers especially hostile takeovers, and restrict these practices in a manne consistent with the original purposes of the Williams Act.

A. Our inquiry should begin with an identification of those practices which you consider to be abusive?

B. Which of these abusive tactics do you consider to benefit the target and which do you consider to benefit the bidder?

C. Implicit in your criticism of the present regulation of the market for corporate control is that the Williams Act is inadequte. What has changed since the 1968 Act that enables you to state the Williams Act is no longer working? What changes do you recommend? Must all of these changes be accomplished through legislation?

Answer to Q. 4. A. I consider the following practices used in connection with, or related to, tender offers to be abusive:

i. Insider trading

ii. Two tier offers

iii. "Sweeping the street" tactics

iv. Large accumulations of stock during the ten day period following crossing the 5% threshold before making the required report under Section 13(d) of the 1934 Act

v. Commencing a tender offer without the offeror having firm commitments with respect to the financing of the offer

vi. Excessive leveraging of acquisitions

vii. Representations in Section 13(d) filings that stock acquisitions were made for "investment" purposes when in truth the purpose was in anticipation of commencing a tender offer, "putting the company in play," or soliciting greenmail

viii. Greenmail.

B. All of the above abuses favor bidders except for viii.

C. Since the enactment of the Williams Act in 1968, we have learned a great deal more about the tender offer process than was known then. During the time since then, bidders have developed a number of techniques which circumvent the purposes of the Williams Act, e.g., the quick accumulation of vastly more than 5% of a class of stock during the ten day period before notification if required. Furthermore, financial markets have changed and the onset of computerization of the markets has permitted activities not foreseen in 1968. Financing means now available were not available in 1968. Most important, we have nineteen years of experience in dealing with these matters.

As for changes I recommend, they are indicated above. I believe these changes must be accomplished through legislative enactments.

Q. 5. Many hostile takeovers, leverage buy-outs and friendly takeovers have been partial or two-tier offers.

A. Has the frequency of partial or two-tier offers increased since 1984?

B. What are the benefits that shareholders realize from these offers?

C. What are the problems attendant to thse offers?

D. Are you aware that SEC studies demonstrate that shareholders receive a higher premium in two-tier offers than they do in any and all or partial tender offers?

E. Do you know what percentage of two-tier offers are negotiated offers and which are hostile?

F. Would you be surprised to learn that statistics compiled by the sec for the years 1981-1984 demonstrate that virtually all (35 of 38) of successful two-tier offers were not hostile? Therefore only 3 of the 38 two-tier offers were hostile?

G. Do two-tier offers have a different impact on a surviving entities debt to equity ratios than successful any-or-all tender offers, partial tender offers, friendly offers or leveraged buy-outs?

H. Should we consider any legislation that restricts the use of two-tier offers?

Answer to Q5. A. I do not believe the frequency of partial or two tier offers has increased since 1984, although I am not aware of statistics indicating the validity of this judgment.

B. In any tender offer shareholders of targets generally realize a price for their shares in excess of the price of their stock prior to the offer. There is evidence the shareholders of the bidder often suffer a loss as a result of offers.

C. Two tier offers tend to favor large and institutional investors since experience indicates that smaller shareholders will often fail to realize the consequences of not tendering, thus shifting benefits they should enjoy to the larger and institutional shareholders who rarely if ever miss such an opportunity.

D. I am familiar with the SEC study referred to, but I am also aware of other information that tends to dispute the benefits purportedly accruing under two tier offers.

E. and F. I have no reason to dispute the information developed by the SEC with respect to the relative incidence of friendly and hostile two tier offers.

G. If a two tier offer is accomplished in part with stock rather than cash secured through the incurring of debt, then such offers should tend to result in more conservative debt to equity ratios than if the offer were done in one stage all with cash secured through the incurring of debt. As for the other comparisons requested, I do not feel that such comparisons can be made, for instance, comparing two tier offers with friendly offers is difficult since two tier offers are often (in fact, according to the SEC study, usually) friendly.

H. Hostile two tier offers seem to have diminished in incidence, hence legislation directed to such offers may not be warranted. A requirement that the acquisition of more than a specified percentage of stock e.g., 20%, be accomplished by an offer for all stock of the class outstanding would eliminate any possible detriments flowing from two tier offers.

Q. 6. A. Is the incidence of insider trading more prevalent during friendly or hostile transactions?

B. Should we curb all takeover activity to stop or curtail insider trading?

C. Recent SEC data demonstrate that insider trading is more prevalent in friendly rather than hostile transactions. Can you provide this tendency? Isn't the reason due to the fact that more people are involved in the execution of a friendly rather than a hostile transaction?

Answer to Q. 6. A. I have no information concerning the relative incidence of insider trading in connection with friendly and unfriendly tender offers.

B. All takeover activity should not be curbed to stop or curtail insider trading. While tender offer activity provides powerful temptations to use undisclosed information unlawfully, those abuses are not inherent in tender offers and such activity does not necessarily have to accompany tender offers.

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C. I do not know why, if it is true, insider trading is more associated with friendly than with hostile offers. One explanation might be that the number of friendly acquisitions vastly exceeds the number of hostile ones, hence there would tend to be, in absolute terms, more insider trading associated with friendly offers.

Q. 7. I assume you are familiar with the report of the SEC advisory committee on tender offers.

In that report the advisory committee makes 50 recommendations for either legislative or regulatory reforms of the system governing corporate takeover transactions. I would appreciate your views on the legislative recommendations contained in this report.

Answer to Q. 7. Responding to each of the fifty recommendations of the SEC Advisory Committee on Tender Offers is a monumental task which cannot be completed within the permissible time frame for submission of these responses. If a full response is wished, I would be pleased to prepare such if enough time were afforded.

Q. 8. [illegible] you think legislation should be enacted that prevents the execution of unconventional tender offers such as the Hanson Trust-SCM takeover battle or the campeau allied stores takeover battle?

Answer to Q. 8. I think legislation should be enacted to prohibit "sweeping the street" as was done in the Hanson Trust-SCM and Campeau-Allied Stores tender offers. See 1.iv. above.

Q. 9 If you want to prohibit two-tier and partial takeovers aren't you essentially insulating most of the incumbent managements from the pressure of outside competition since their acquisition by smaller companies would almost be made impossible?

Answer to Q. 9. Enactment of legislation such as suggested to require that any acquistion of stock beyond a specified threshold be done by tender offer is a means of protecting shareholders and assuring that more of them will receive the benefits of the premium paid. As a consequence of the ready availability of financing, smaller companies have been able to make any-and-all offers for larger companies.

Q. 10. Chairman Proxmire seems to have focused his attention on hostile corporate takeovers. However, the Williams Act does not define the term "tender offer" so how can any legislation we enact specifically address "hostile tender offers" without providing definition of a "tender offer?" Absent such a distinction wouldn't legislation aimed at hostile tender offers affect all tender offers?

Answer to Q. 10. In my estimation the legislation I endorse does not have to speak in terms of "hostile" or "friendly" tender offers, and there is no need to define either those terms or for that matter, the term "tender offer" itself. What should be done is to proscribe certain practices. Those practices usually occur in connection with hostile tender offers, but there is no need to so indicate legislatively.

Q. 11. The 1985 annual report of the Council of Economic Advisers states, "the best assurance an incumbent management has against a successful takeover attempt is a stock price that is high relative to outsiders' estimates of the potential value of the corporation's shares. Managements that allocate capital to higher valued uses, operate efficiently, and adopt capitalization structures responsive to prevailing financial market conditions are less likely to be subject to takeovers than other management groups. Consequently, in order to prevail in the external market for corporate control, it is not enough that an incumbent management believes that it is doing a proper job, or that it persuades stockholders that it is doing so. Instead, management must demonstrate that its performance is competitive with the performance of other potential managers, and the value of management's performance must be reflected in the corporation's stock price. In this fashion, the external market for corporate control disciplines managers who believe they have maximized the value of the corporation's shares when, in fact, they have not."
What is your response to the argument expresed here that if target companies had been managed to maximize shareholder wealth they would not have ended up as "targets"

Answer to Q. 11. I regard the quotation from the 1985 Annual Report of the Council of Economic Advisers to be specious.

It is widely recognized that stock price is a poor indicator of the quality of management. Many factors impact the price of stock -- macroeconomic factors, interest rates, state of public confidence in the economy. Burton Malkiel, a former member of the Council of Economic Advisers, has said.

> There is, I believe a fundamental indeterminateness about the value of common shares even in principle. God Almighty does not know the proper price-earnings multiple for a common stock.

Moreover the evidence is clear that more often than not well-managed companies are the targets. Furthermore, in many instances incumbent managements have been kept in place following a takeover.

Q. 12. The 1985 Annual Report of the Council of Economic Advisers states

> "to the extent that government regulations impose costs on bidders, or reduce a bidder's chances for success, fewer takeover attempts will be made. This tends to insulate corporate managements from the competitive pressures of the external market for corporate control. Stockholders as a group will also suffer as a result of excessive regulation because it reduces the chance to earn takeover premiums."

How do you refute this argument?

Answer to Q. 12. At the present time managers are subject to innumerable pressures for them to perform. They are subject to the pressures of outside directors, commercial and investment bankers, institutional investors, the financial press, not to mention the marketplace for the goods and services their corporations produce. If a corporation is not performing, one or more of these sources of pressure will compel that performance be improved or the management will be ousted. The newspapers record innumerable instances weekly in which managements have been ousted and not because of any takeover threat.

As for the argument that if takeovers are restricted target shareholders will be denied a premium, it is based on the assumption that the only value to be considered is that of the shareholders of the target companies. Takeovers inflict considerable mischief on the society and the economy, including the foreshortening of management perspective and the discouragement of long-range planning and investment (a prime example is Goodyear which had to abandon its long-range and well thought out plans in order to avoid a takeover by Sir James Goldsmith).

Q. 13. What is your response to the following statement which appeared in the 1985 Annual Report of The Council of Economic Advisors?

> ". . . The current state of knowledge strongly indicates that further federal regulation of the takeover process, particularly insofar as it would make takeovers more costly, would be poor economic policy."

Answer to Q. 13. I strongly disagree that the "current state of knowledge" indicates that further regulation of tender offers would be poor economic policy. On the contrary, I think such curbs would be good economic and social policy, and in this conviction I am joined by innumerable people, including all the witnesses who have appeared before the Committee during the current round of hearings and including such estimable authorities as Peter Drucker and Warren Buffett.

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Q. 14. The 1985 Annual Report of The Council of Economic Advisors states:

> "the available evidence, however, is that mergers and acquisitions increase national wealth. They improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management. They also help recapitalize firms so that their financial structures are more in line with prevailing market conditions. In addition, there is no evidence that mergers and acquisitions have, on any systematic basis, caused anticompetitive price increases."

The report goes on to state:

> ". . . There is no economic basis for regulations that would further restrict the merger and acquisition process."

Given the fact that mergers and acquisitions taken in the aggregate are beneficial to society and the economy would you propose somehow to distinguish between "good" and "bad" acquisitions?

Answer to Q. 14. The statement in the Council of Economic Advisers Report that "The available evidence . . . is that mergers and acquisitions increase national wealth" (emphasis supplied) is erroneous. To the best of my knowledge there is no such evidence. On the contrary, there is considerable evidence that this simply is not true, including the researches of F.M. Scherer, a distinguished professor at Swarthmore College. Moreover, Michael Jensen, a well-known proponent of unregulated tender offer activity, acknowledges that in mnay instances the stock of the acquiring company goes down following announcement of a takeover, thus offsetting gains that may be realized by target shareholders.

In short, there is little evidence to support the contention of the Report.

Q. 15. The 1985 Annual Report of the Council of Economic Advisers states:

> "the evidence also suggests that abusive practices in the market for corporate control are limited largely to tactics employed by target managements who, in opposing takeover bids, defeat or deter tender offers at the expense of their stockholders and the economy."

How do you defend the defensive actions of management and should legislation be introduced to eliminate these types of abuses?

Answer to Q. 15. **I believe abuses of all kinds should be eliminated from the tender offer process, whether they are the work of the targets or the bidders. However, I strongly oppose denying targets the means to fend off tender offers until there is more comprehensive and effective regulation of the bidders.**

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM FRANCIS M. WHEAT

Q.1. In your prepared statement on page 5, you include among the adverse effects of takeovers a reduction of U.S. corporate competitiveness abroad. You point out that takeover threats divert enormous amounts of management talent from the long range planning and research that is needed to become and remain competitive internationally. In saying this, you are also saying that the kind of takeover activity we are experiencing in this country is not occuring in the markets of our main international competitors -- Japan, West Germany, other countries in the Pacific Basin and in Europe. If this is so, why are takeovers not a problem in those countries. What laws, regulations, or practices do they have that we should consider encouraging in our country? What factual basis do you have for saying that hostile takeovers are adversely effecting our international competitive position?

A- Q1. I believe takeovers are not a problem in the countries referred to because (i) the business traditions in these countries are radically different from those current in the U.S. and (ii) because of the heavy governmental involvement in business in Japan.

I am not aware of any laws or practices in those countries which we should consider adopting, and would not favor the kind of government involvement in business which I understand takes place in Japan.

As to hostile takeovers adversely affecting our international competitive position, I base my statement largely on the views, which I greatly respect, of professor Peter Drucker and partly on my own observation of the reduction in funds spent on R and D by companies which have tried to defend themselves in the takeover wars.

Q.2. A witness for the Reagan Administration has contended before this Committee in the past that hostile takeovers are beneficial to the economy and that concerns about the negative effects of takeovers are "often unfortunately rooted in a desire to preserve the status quo of existing corporate structure in a fashion that can be harmful to stockholders and the economy."

You take strong issue with that view and state on page 2 of your testimony that the "damaging consequences outweigh one hundred fold the benefits" of hostile takeovers. You also quote Mr. Peter Drucker, a very distinguished business professor, as saying hostile takeovers have become "almost certainly a major factor in the erosion of American competitive and technological leadership."

Can you explain why you agree with Mr. Drucker and not the Reagan Administration on this issue.

A- Q2. My answer to this question is contained in the whole of my prepared testimony.

2
Proxmire — Wheat

Q.3. Please list and clarify exactly what abuses you believe are occuring in the conduct of hostile takeovers.

A-Q3.A. Purchases by takeover enterpreneurs of positions in the targets stock followed by efforts sometimes simply through publicity, to get the target "into play" so that the purchaser can sell out to another bidder at a profit, without ever having to make a genuine bid himself.

B. Threats by the prospective bidder to restructure or break up the target, impelling the management to defend the target from break-up by incurring enormous debt and transferring the debt proceeds to the stockholders, to the profit of the prospective bidder.

C. The stimulation (in order to forestall a hostile bidder) of privatization of American business through leveraged buy-outs, which result in businesses vulnerable to any downturn in the economy and an increasingly disturbing reduction in the diversity, scope and (potentially) in the strength of our public equity capital markets

D. Providing vast opportunity for insider trading, as noted in my prepared testimony, which will erode public confidence in the securities markets.

E. Abusive front-end loaded partial tender offers which frighten shareholders into tendering their shares.

F. The absence of enough time for managements of targets faced with an actual hostile offer to study the situation and to determine the best course of action in the interests of the shareholders, rather than to react under pressure. The period prescribed by the Williams Act is far too short for this.

G. Where a takeover is successful, in many cases the target is broken up and the pieces sold off or (in some cases) closed up, with resulting unemployment.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM FRANCIS M. WHEAT

Q. 1. **The fundamental policy espoused by the Securities Acts passed in the 1930's was full and fair disclosure. That is, if adequate information is provided to the marketplace, very little government intervention should be necessary. In passing the Williams Act in 1968, Congress determined that tender offers should not be regulated as an economic phenomenon and investors could be protected through disclosure and limited procedural safeguards. Should we backtrack on that fundamental policy and allow the government to sit in judgment on the economic merits of takeovers?**

A- Q1. I would oppose allowing "the government to sit in judgment on the economic merits of takeovers" while at the same time I am satisfied that, as the result of the enormous advantage presently possessed by the aggressor in the takeover game, total reliance on "disclosure and limited procedural safeguards" is wholly inadequate.

Q. 2. **On page 2 of your testimony, you cite peter drucker in your condemnation of hostile offers — . . . "The hostile tender offer has become . . . A major factor in the erosion of american cometitive and technological leadership." Please cite which industries have experienced a diminished capacity in competitive and technological leadership as a result of hostile takeovers. Please cite specific examples of takeovers within these industries to substantiate your statement.**

A- Q2. The hostile attacks on Gulf, Union, Phillips and others in the oil industry resulted in very costly acquisitions or debt-laden restructuring, which significantly reduced the ability of these companies to commit substantial, long-term capital to research and development of new products.

Q. 3. **The study of what modifications to the Williams Act are required is not a new subject before the Committee. Past experience has demonstrated that any attempt to restrict or prohibit "hostile offers" has an unintended negative impact on friendly takeovers and leveraged buy-outs. Therefore, the task before this committee is to identify those abusive practices that are attendant to all corporate takeovers, especially hostile takeovers, and restrict these practices in a manner consistent with the original purposes of the Williams Act.**

A. **Our inquiry should begin with an identification of those practices which you consider to be abusive?**

B. **Which of these abusive tactics do you consider to benefit the target and which do you consider to benefit the bidder?**

C. **Implicit in your criticism of the present regulation of the market for corporate control is that the Williams Act is inadequte. What has changed since the 1968 Act that enables you to state the Williams Act is no longer working? What changes do you recommend? Must all of these changes be accomplished through legislation?**

A- Q3.A. I consider (i) the front-end-loaded partial tender offer, (ii) the effort through secret purchase of a sizeable block of target stock to get the target "into play" so the entrepreneur can expect to sell out at a quick profit to someone else into whose arms he has driven the target, and (iii) the seeking of greenmail at the expense of the public shareholders of a target to be abusive. But the real problem is not so much these abuses as the relative defenselessness of targets in the face of the easy credit, ability to operate in secret, and activity of the arbitrage commuinity, all of which can be taken advantage of (without any "abusiveness") by takeover entrepreneuers.

B. I hope the above adequately answers question B.

C. In the years since the Williams Act, it has come to be recognized that targets are largely defenseless (unless they restructure to their great disadvantage, or go private, or sell out to someone else) and, what is almost as bad, their managements and boards must react to a hostile tender offer under intense pressure, which sometimes produces defensive decisions which cannot be, and are not, thoughtfully considered.

The SEC belatedly recognized the above by its rule changes lengthening somewhat the time during which tender offers must remain open. I would like to see a still longer period and--as my testimony shows--a larger role for the independent directors of the target in determining whether a hostile tender offer should proceed. Such changes would have to be accomplished through legislation.

Q. 4. Many hostile takeovers, leverage buy-outs and friendly takeovers have been partial or two-tier offers.

A. Has the frequency of partial or two-tier offers increased since 1984?

B. What are the benefits that shareholders realize from these offers?

C. What are the problems attendant to these offers?

D. Are you aware that SEC studies demonstrate that shareholders receive a higher premium in two-tier offers than they do in any and all or partial tender offers?

E. Do you know what percentage of two-tier offers are negotiated offers and which are hostile?

F. Would you be surprised to learn that statistics compiled by the SEC for the years 1981-1984 demonstrate that virtually all (35 of 38) of successful two-tier offers were not hostile? Therefore only 3 of the 38 two-tier offers were hostile?

G. Do two-tier offers have a different impact on a surviving entities debt to equity ratios than successful any-or-all tender offers, partial tender offers, friendly offers or leveraged buyouts?

H. Should we consider any legislation that restricts the use of two-tier offers?

A-Q4.A. I do not believe so.

B. Shareholders may realize a benefit through a higher than current market price for part of their shares. This benefit may be offset by (i) a poorer, or lower-priced market for the balance of their shares, or (ii) the loss of the opportunity which the target management might have been able to afford them to hold their entire investment for a much higher sellout price at a future date more propitious for the sale of the entire company.

C. See B above. In addition, the two-tier offer puts unusual pressure on shareholders to tender their shares, for otherwise they may be left with their entire investment in shares for which the market has been lost or impaired.

D. No.

E. No.

F. I would be inclined to question whether such bare statistics are meaningful without analysis of each such tender offer. Many non-hostile tender offers are the result of hostile tender offers, and have similar results.

G. I do not believe I could give a meaningful answer to this question.

H. Yes.

Q.5. A. Is the incidence of insider trading more prevalent during friendly or hostile transactions?

B. Should we curb all takeover activity to stop or curtail insider trading?

C. Recent SEC data demonstrate that insider trading is more prevalent in friendly rather than hostile transactions. Can you provide this tendency? Isn't the reason due to the fact that more people are involved in the execution of a friendly rather than a hostile transaction?

A- Q5.A. I have made no study of the situation and therefore any answer I might give would be wholly guesswork.

B. No.

C. I am not familiar with such data and therefore cannot answer the question. Moreover, I suggest the data be reviewed carefully. Much insider trading occurs during hostile advances which do not result in a hostile tender offer but do result in driving the target into the arms of a white or grey knight, in what the SEC doubtless classifies as a "friendly" tender offer.

Q.6. Do you believe that the payment of greenmail to a potentially hostile raider is preferable to the initiation of a hostile takeover?

A- Q6. Under some circumstances it clearly is.

Q.7. Would the shareholders of the company paying greenmail benefit more from the elimination of a potential hostile raider than from the execution of a successful hostile takeover initiated by a bidder?

A- Q7. It would, of course, depend entirely on the factual circumstances.

Q.8. In September 1984, the SEC released a study concluding that greenmail payments adversely affect the shareholders of the greenmailed company. The report stated:

> "the evidence suggests that non-participating shareholders suffer substantial and statistically significant share price declines upon the announcement of targeted repurchases at premiums above market value. The overall impact on share prices from the date the initial foothold position is established to the date the block is repurchased is also negative . . . We conclude that the overall impact of targeted share repurchases on the wealth of non-participating target shareholders is negative. The stock price evidence indicates that the magnitude of the losses to non-participating target shareholders is at least equal to the wealth loss implied by the cash premium paid for the block purchase."

A. Do you agree with the SEC's conclusions?

B. Do you believe that legislation is required to restrict or prohibit the payment of greenmail?

A- Q8. I regret to say that such analyses, based entirely on market price action, seem to me to miss the problem.

Only if significant legislation is enacted to eliminate the advantage possessed by takeover aggressors. In that case, I would welcome the elimination of greenmail by appropriate legislation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

D. M. RODERICK

QUESTION

Currently, Section 13(d) of the Securities Exchange Act and the rules thereunder require that persons beneficially owning 5% or more of a company's stock report that ownership, along with other related information, within 10 days of reaching that level. Many people have agreed that the 10-day "window" is too long, and that it should be substantially shortened. What other deficiencies do you see in the current reporting requirements under this Section of the Act?

ANSWER

Five percent ownership of stock before there is a reporting requirement is, I believe, much too high. I think that reporting should be mandatory when a person obtains one percent of a corporate stock, and the reporting of that purchase should be made within twenty-four hours after the stock is acquired. If the reporting period is any longer than twenty-four hours, then I believe the acquiring person should be precluded from buying further stock until such time as the notice of his previous purchase is made public. Furthermore, I think a better definition is required of what constitutes parties acting together or in concert in ascertaining when the percentage level of stock ownership is attained. Finally, I would make the legislative sanctions much tougher for anyone violating any of these 13D requirements.

QUESTION

The argument is made that hostile tender offers are good for the economy because they produce a more efficient use of corporate assets by permitting the free market to move the assets to those who can earn the highest rate of return from them, and are good for shareholders because they give them immediately the real value of their shares. Do you agree with this view?

ANSWER

I do not believe that hostile tender offers should be prohibited nor should they be unreasonably restricted. Stockholders should not be denied the benefit of an efficient, free market for their stock. It is the abuses that permit games to be played for the enrichment of the raider and not for the benefit of all the shareholders which should be curbed.

I am very dubious that hostile takeovers produce a more efficient use of corporate assets. Too often, the acquisition results in such a highly leveraged company that efficiencies are actually lost because flexibility and opportunities are foreclosed to a corporation burdened with so much debt. In many of these excessive debt situations, the only viable alternative is to bust up the enterprise and sell off assets to reduce the debt without regard to the long-term efficiencies of the company. And the turmoil, uncertainty, and substantial costs connected with these takeovers most certainly are very negative factors working against an efficient operation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM ANDREW C. SIGLER

Your first question is as follows:

> It is commonly said that two-tier and partial tender offers are detrimental to shareholder interest. Do you agree with that position, and, if so, can you give us some examples of abusive two-tier and partial offers and explain why they are detrimental to shareholder interest?

In my view, such offers can be coercive and deprive shareholders of a fair chance to receive a full control premium for all their shares.

In two-tier offers, the raider offers cash to acquire generally less than all of the shares of a target, but still a sufficient number to give the raider control. (Such control can be 50%-70% of the target's stock, but control can also mean less than 50%.) In his tender offer documents, the raider states that, once he has acquired control, he will cause the target company to enter into a merger in which its remaining shareholders will receive an amount less than, or in a less desirable form than, the price offered in the tender offer.

When faced with the first-tier, cash portion, of a two-tier offer, a target shareholder is faced with a dilemma: Whether or not the shareholder is satisfied with the price being offered in the first tier, he would risk getting an even lower price if he does not tender and the raider acquires control and forces a second-stage merger. Because the first tier offer is usually at a substantial premium above the market price, most stockholders are not willing to take the chance that enough other stockholders would refuse to tender so that the tender offer would be defeated. The result is that enough shares usually are tendered to make the tender offer successful, whether or not the overall consideration being paid for the company fairly reflects its value.

Partial offers can have the same effect as two-tier offers. Indeed, in some way partial tender offers are even more coercive because the shareholder does not know, when making a decision whether or not to tender, what he will obtain in the future, if anything, for those of his shares that are not purchased in the tender offer. One thing he does know is that the target's stock is likely to decline after a raider acquires control in a partial tender offer; once the raider has control, he is not likely to offer a control premium to purchase further shares.

Partial offers also permit the raider to acquire effective control by paying a control premium for less than all of the shares. And, while a partial tender offeror may not disclose his plans for the remaining shareholders, he could always force onto the remaining shareholders a second-stage transaction, at an unfairly low price. One such example is Mesa's raid on General American Oil, in which Mesa sought more than 50% of General American's shares, which, according to Mesa documents, would enable Mesa to "replace all of the [General American] board" and force the remaining shareholders to accept "debt or equity securities of Mesa, or a combination thereof, on such terms and in such amounts as Mesa may determine."

For these reasons, two-tier and partial tender offers circumvent and undermine the Williams Act's goals of fairness and equal treatment of all shareholders and permit raiders to gain control at the expense of the remaining shareholders. This is particularly the case when the raider uses debt securities in the second stage that are secured by the target's assets in order to finance the raider's acquisition costs. As Martin Lipton has noted, two-tier and partial tender offers are "devices through which unsophisticated shareholders are taken advantage of by professional investors. . . .

They are devices by which a target's own balance sheet is used to finance a raid."

Even Boone Pickens, the leading spokesman for corporate raiders, believes that two-tier offers can be coercive. When Cities Service made an offer of $21 for half of the stock of Pickens' Mesa Petroleum Company and announced that the remaining half would be exchanged for Cities' securities, Pickens labeled the offer "as coercive as you can get" and "unfair to Mesa's stockholders."

Yet Pickens, like the other raiders, has utilized two-tier offers. When Mesa went after Unocal, it offered $54 per share cash for a majority of Unocal's shares, with the remaining shares to be purchased with debt securities which Mesa claimed were worth $54 per share. However, the value of the debt securities was at best uncertain and clearly less valuable to Unocal's shareholders than cash. The Delaware courts agreed, terming Mesa's offer a "grossly inadequate and coercive two-tier, front-end loaded tender offer."

Pickens' frequent use of the partial offer as a tactic demonstrates another reason why it is subject to abuse. The partial offer is sometimes used as a means of putting a company in play, not in order to acquire the company, but in order to profit from resulting transactions such as competing bids or corporate restructurings. In the last five years, Pickens' companies have made offers for an amount of stock sufficient to raise his group's stake in Gulf Oil from 13% to 21%; for an amount of Phillips Petroleum stock necessary to raise Mesa's stake to as much as 20% of Phillips; and for an amount of Unocal stock necessary to raise Mesa's stake to just over 50% of Unocal. Had Pickens succeeded in acquiring control of any of these companies, he would have avoided paying a fair share of the control premium to all shareholders. More importantly, not one of these targets was actually acquired by Pickens; in all cases he sold out at a handsome profit. Indeed, in the case of Gulf Oil, Pickens even admitted in his autobiography, Boone, that he never had any intention of acquiring Gulf Oil, and that his partial tender offer was made only in an effort to earn a quick profit.

Other recent examples of coercive two-tier tender offers include:

- Saul Steinberg's two-tier offer for John Blair, with the first tier a cash tender offer at $31 per share for 61% of John Blair's shares, and the second tier an exchange of stock and junior subordinated discount debentures for the remaining shares. The cash offer was over-subscribed by shareholders, who obviously preferred that offer to the paper consideration being paid in the back end;

- NV Homes' offer for Ryan Homes for $48 in cash for 45% of Ryan, with the remaining shares to be exchanged for cash and securities with a total asserted face value of $48 per share;
- Allied Corp. and Ultramar PLC's combined acquisition of Enstar Corp., in which they paid $20 per share in cash for 50.4% of Enstar's stock and a combination of $2 per share in cash and participation certificates in an Indonesian natural gas drilling joint venture for the remaining stock; and
- Allegheny International's acquisition of Sunbeam Corp., in which it purchased 49.6% of Sunbeam's shares through a $41 per share cash tender offer, and then initiated a back-end merger in which it exchanged shares of a new issue of its convertible preferred stock with a nominal market value of approximately $32 for each remaining Sunbeam share.

These examples only serve to reinforce my belief that two-tier and partial tender offers are coercive and unfair tactics which act to the detriment of shareholders and thus should be prohibited.

* * *

Your second question is:

> A number of people contend that hostile takeovers are an essential check on management inefficiency and waste. Yet many of the witnesses at this hearing and other commentators have disputed this argument. What is your response to the argument that hostile takeovers are an essential check to entrenched management?

The argument that hostile takeovers serve as a check on entrenched management can be rebutted on two different levels. First, studies show that management of target companies do not underperform and hostile takeovers generally do not result in any improvement in the competency or efficiency of management. Second, other forces serve as a check on management entrenchment, and there is no support for the argument that hostile takeovers are necessary to discipline management.

PERFORMANCE OF TARGETS

The position that mergers enhance economic efficiency is premised on the belief that targets are poorly managed and less profitable than nontargets. However, studies indicate that target firms are not economically underperforming relative to other firms: the operating income averages of the targets are only slightly lower than that of the peer group averages,[1] and the average return on stockholders' equity for targets in the two years before a tender offer closely approximates the average return of all U.S. nonfinancial corporations.[2] In the face of this empirical data, it is clear that tender offers are not directed particularly at corporations with wasteful or inefficient management.

In addition, virtually all studies show that, following successful hostile tender offers, the market value of the bidder's stock over the long-term generally decreases. Simply put, the resulting company does not perform as well as its constituents.[3] Obviously, such an outcome seriously harms, not helps, society as a whole.

Having participated in friendly acquisitions, I can also assert that companies seek to acquire companies which are performing well and which are in a position for prospective growth. Target management is never so obviously inefficient or incompetent that one would be anxious to acquire an unprofitable business with the hope of making it profitable. More typically, factors other than mere management ability have contributed to a potential target's difficulties. Generally, the target will not be acquired unless those other difficulties can be resolved or handled.

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[1] F.M. Scherer, Testimony before the Subcommittee on Telecommunications and Finance, House Subcommittee on Energy and Commerce, April 1, 1987.

[2] Scherer, supra note 1, citing Herman & Lownstein, The Efficiency Effects of Hostile Takeovers: An Empirical Study (working paper no. 20, April 1986).

[3] Magenheim & Mueller, On Measuring the Effect of Acquisitions on Acquiring Firm Shareholders, unpublished paper at 43-44.

Corporate raiders -- those who make hostile offers in order to make a quick profit -- are even less attuned to inefficient management as a criterion for target selection. Raiders, as opposed to operating companies, generally do not bring to the table any management capacity. Instead, these raiders typically leave incumbent management in place, and thus cannot contribute to any improvement in management. The only goal of the raider is to profit himself through greenmail or a "restructuring." Moreover, a restructuring cashes out a portion of the equity at a premium while subjecting the remaining equity and all existing bondholders to far greater risk because of the extraordinary debt levels. Thus, these types of transactions are not profitable because of new, superior management, but because of the raider's ability to reap a premium and leave others bearing the financial burdens.

It has been suggested that hostile bids are made because the acquiror believes that the stock market undervalues the target's assets, and that such undervaluation is itself an indicator of inefficient management. A low stock price is inaccurate at best as a measure of management inefficiency and waste. A stock's price may be undervalued because of industrywide problems, long-term investments that are not reflected in short-term profits, adverse developments that have occurred despite the best of management, or market misperceptions. Similarly, a stock's price may be elevated by comparable factors despite management inefficiency and waste. For example, the Dow Jones index has increased twenty percent over the last quarter. However, no one would argue that managements have gotten twenty percent more efficient or smarter over the last ninety days.

Even if one were willing to assume that targets are acquired because bidders believe that they can manage the target more efficiently, the evidence does not correlate takeover activity with improvements in management. In fact, as mentioned previously, studies based on stock price indicate that the actual post-takeover stock price performance of the combined entity over a significant time period is frequently worse than that of the acquiring company prior to the takeover.[4] The studies that have reached a contrary conclusion have relied on very short-term (only up to 40 days) price movements.[5] Studies based on accounting data measuring lines of business within companies, rather than conglomerated companies as a whole, indicate that acquirors have not succeeded in improving the performance of the targets. And cash flow performance of target lines of business show no significant variation from unmerged lines of business.[6]

In the takeover market, today's bidder may be tomorrow's target or vice versa -- without any change in management. Perhaps the most dramatic instance of this phenomenon occurred between Martin Marietta and Bendix Corporation, when each simultaneously sought to take over the other. More recently, we have seen situations such as Chesebrough-Pond's Inc., which acquired Stauffer Chemical Company in 1985 only to find itself, in 1986, taken over by Unilever Corporation. Clearly management's capabilities have nothing to do with who is taken over. Rather, these battles are won on the basis of the gamesmanship of investment bankers and lawyers.

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[4] Magenheim & Mueller, supra note 3.

[5] See, e.g., Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 Journal of Financial Economics 5.

[6] F.M. Scherer, supra note 1.

CHECKS ON ENTRENCHMENT

One might surmise, upon reading some defenses of the tender offer process, that in the absence of hostile offers managers would be free of any pressure to operate their corporations competently. In fact, as virtually any corporate officer can testify, other and more immediate concerns provide powerful incentives for management to perform efficiently.

The best check on corporate mismanagement is by those with a close, regular, ongoing relationship with the corporation: outside directors, principal shareholders (which, with increasing frequency, are institutional investors with sufficient incentive and capability to monitor such matters), debtholders and other lenders, suppliers and customers. No manager can safely ignore the demands that are placed upon it by these constituencies.

Given the current prominence of shareholder derivative suits, corporate officers and directors have a strong personal financial incentive to avoid mismanagement and waste. More positively, stock incentives, in one form or another, are a significant portion of the compensation for most corporate officers, providing them with a direct and substantial economic stake in the well-being of the corporation.

From an empirical standpoint, it appears clear that these types of constraints are sufficient to encourage efficient management, even without the additional impetus of hostile tender offers. In Germany and Japan, for example, hostile takeovers are virtually nonexistent. The strength of the German and Japanese economies reflects the ability of other economic forces to discipline management. Similarly, U.S. companies ran efficiently and performed well over the decades prior to the late 1960s despite the absence of hostile takeovers.

In view of this evidence, it is clear that hostile tender offers are not necessary, or even effective, to promote efficiency.

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Chairman and Chief Executive Officer

Champion
Champion International Corporation

May 8, 1987

The Honorable William Proxmire
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Dear Senator Proxmire:

I am pleased to have the opportunity to respond to an additional question which you have requested be answered in connection with the hearings held before your committee on March 4, 1987.

You have asked the following question:

> It has been alleged that nowadays a company can be "put into play" without an acquiror having to put up any real money. Is this in fact the case, and could you give us an example of this? What should be done to ensure that bidders put up some of their own money in these deals?

It is not only possible, it is quite simple and happens quite frequently. Indeed, under current rules and tactics, acquirors are able to achieve complete takeovers of companies many times their own size without having to put up their own money by issuing so called "junk securities" and using the target company's assets as collateral. The lure of these "no money of your own" takeovers has made possible and encouraged takeovers which would have been impossible if the acquiror had to use its own resources to finance the takeover. Such takeovers have heightened the current takeover frenzy, increasing dramatically the number of takeover bids in recent years, as well as the stock speculation that accompanies and further fuels such bids. Because these acquisitions are so heavily leveraged, they must, of necessity, be structured as "bust-up" acquisitions. Such acquisitions have devastating consequences to both the target company and its employees.

Corporate raiders have developed a related abusive tactic in order to turn a quick profit. Because junk bonds enable any person to take over any company, no matter how large, the threat of a junk bond-financed takeover gives even the smallest company, with the right investment banker, credibility in threatening targets with takeovers. As a result, raiders making or threatening a junk bond-financed takeover can put a company into play in order to make a quick profit from the disruption that results. The target buys out the raider for an exhorbitant sum and engages in defensive restructuring, hurting the target, its employees and its shareholders.

To understand the problem more fully, a brief description of the regulatory background that permits takeovers financed wholly with the funds of others, and an example of such a takeover, may be helpful.

Takeovers Financed with the Money of Others

Currently, only the Federal Reserve Board's margin rules regulate the ability of a raider to borrow money to finance takeovers. However, these rules apply only to extensions of credit to purchase certain stocks which are secured, directly or indirectly, by the stock. Such extensions of credit currently are limited to 50% of the market value of the stock being acquired. If the credit is not secured by the stock, the margin rules do not apply. Under current rules, financing through the issuance of "junk" securities is generally not covered by the margin rules because such securities are not collateralized by the target's stock (the only exception seems to be if the borrowing company is a mere shell with virtually no assets or business).

Thus, raiders can borrow from a commercial bank 50% of the market value of the target stock and pledge that stock to the bank. They can borrow the other 50% of the purchase price of the target stock by borrowing the money by issuing junk securities without putting up any collateral and without violating the margin rules.

The raider's investment bankers have become another source of non-margin financing. In return for promises of enormous fees, the investment bankers agree to provide "bridge financing" on an "as needed" basis. For example, in the recently terminated $2.46 billion bid by an investor group headed by Wagner and Brown and AFG Industries for GenCorp, Shearson Lehman Brothers Inc. agreed to provide $1.25 billion of bridge financing in the form of purchases of senior subordinated notes. Merrill Lynch & Co. agreed to provide $1.9 billion of bridge financing in the form of purchases of preferred stock to enable Sir James Goldsmith to make a run at Goodyear Tire and Rubber Co. in 1986. Kidder Peabody agreed to provide up to $750 million in financing for Dart Group's just-terminated bid for Supermarkets General. First Boston did the same for Campeau Corp.'s run at Allied stores.

Through the raiders' use of a combination of bank loans and junk securities or "bridge" financing, the target company in essence pays for the costs of its own acquisition, through post-merger liquidations of portions of its business. This enables companies to finance takeovers of much larger companies. Thus Pantry Pride, with assets of $400 million, was able to secure financing for a $1.83 billion acquisition of Revlon in 1985. GAF Corp., with revenues of $730 million, was able to make a serious $4.8 billion bid for Union Carbide. Dart Group, with 1985 sales of $98 million, was able to make a credible $3.9 billion bid for Safeway Stores Inc.

Raiders also pyramid these junk bond financed acquisitions enabling them to take over successively larger target companies. Using extensive leveraging, Ronald O. Perelman has managed to pyramid an initial investment of $1.9 million in 1978 into a multibillion dollar empire after his Revlon acquisition.

A good example of a successful takeover of a large company by a smaller company using junk bonds and the assets of the target company as collateral is Pantry Pride's $1.83 billion hostile acquisition in 1985 of Revlon. Pantry Pride made a tender offer for Revlon through a subsidiary ("Nicole") created for that purpose. To finance the tender offer, Nicole received funds from three sources. First, Nicole received $340 million in margin credit pursuant to a loan agreement with Chemical Bank. Nicole also received two capital contributions from Pantry Pride. One contribution represented the proceeds of Pantry Pride's issue of $750 million of junk bonds shortly before the tender offer for Revlon. The other contribution represented the proceeds of a $725 million private placement of Pantry Pride junk bonds. The tender offer was successful and the acquisition completed in late 1985. (Revlon unsuccessfully sought to have the

Federal Reserve Board intervene and declare Pantry Pride's two issues of junk debt subject to the margin rules. The Federal Reserve Board did not act on Revlon's petition.) Pantry Pride thus was able to make, and successfully complete, the tender offer and acquisition, without using any money from Pantry Pride's own coffers.

The detrimental and frequently devastating effects of junk-bond financed, "bust up" acquisitions on the target company, its employees and the communities it serves have been widely documented and do not need restatement in detail here. Suffice to say that, among other effects, jobs are lost causing personal devastation for employees and their families when prized assets are sold to repay the junk debt; communities dependent upon the corporation's presence are harmed; and resources are diverted from productive uses such as capital reinvestment and research and development to debt repayment.

Putting Companies into Play To Reap Short-Term Gains

Actually taking over a company with junk bond financing is obviously a significant incentive to corporate raiders. The raider can amass an empire while using the assets of the target company to repay acquisition obligations. But merely threatening such a takeover may produce even better results; raiders can achieve enormous profits without nearly as much effort as is required to run a company and oversee the dismantling of the target company and the headaches such dismantling frequently entails.

These profits are frequently at the expense of the target company's shareholders and employees.

Here is how the scheme works. By threatening such takeovers, raiders put companies into play knowing that the target company will react to the unwanted suitor by buying back, or having some third party such as a white knight buy back the raider's stock in the target at a premium, or giving some other valuable consideration to the raider. A raider first acquires a large block of stock of the target (say 5%) and files a Schedule 13D, making his position publicly known. The raider then makes a hostile tender offer, or publicly announces it is considering making a tender offer, for the remainder of the target's outstanding stock. The target's price immediately jumps in response as the arbitragers move in.

The offer is made subject to receipt of sufficient financing to cover all costs of the tender offer, including the enormous fees of the raider's investment bankers. Of course, no commitments for financing actually need be in place. Raiders often announce bids based on a "highly confident" letter from their investment bankers stating that the banker is highly confident that it can raise the money to fund the takeover. Alternatively, the investment bankers may themselves commit to provide bridge financing on short notice. To make the offer (and threat) appear legitimate and not merely an attempt at greenmail, the raider invariably announces its intent to actually carry out the acquisition. In fact, the raider may have no intention of completing the acquisition. (The facts, of course, speak for themselves, as noted below.)

The target has received an unwanted offer to which it must respond. The raider has the ability and incentive to carry out the acquisition. The raider doesn't need any of its own funds to make or complete the acquisition, since the financing is provided by others and it is the target company's assets which will repay the costs of acquisition. To avoid a complete dismantling of the company and the related devastating effects, the target must free itself from the raider's grasp. This may involve seeking a white knight, undertaking a restructuring through a sale of assets or incurrence of debt, receiving competing bids or even paying greenmail. In any event, the raider's shares are repurchased at a premium over what was paid for them and the raider has managed to turn a quick, speculative profit.

The following represent just a few instances in which corporate raiders have profited by threatening, but not completing, a hostile acquisition:

- Dart Group's $3.9 billion tender offer for Safeway. Safeway defended by arranging a leveraged buyout by Kohlberg, Kravis and Roberts ("KKR"). As part of its buyout of Dart, KKR gave Dart an option on 20% of the holding company KKR created to acquire Safeway. Dart two months later sold the option back for $59 million, giving it a total reported profit on its takeover bid of $80 million. In another transaction, Dart reportedly also received a premium for a 4.5% stake in Federated Department Stores when Federated repurchased the Dart-held shares in order to avert a potential takeover battle.

- Sir James Goldsmith's bid in 1986 for Goodyear Tire and Rubber Co. To defend, Goodyear was forced to undertake a massive restructuring and repurchased Sir James' Goodyear stock for $618.8 million, which gave him a reported profit of $93 million. Goodyear also agreed to pay $37 million of Sir James' expenses.

- Wagner and Brown's and AFG Industries' bids for Lear Siegler in 1986 (they received a combined gross profit of approximately $38 million after Lear Siegler arranged for a leveraged buyout by Forstmann Little) and their recently terminated bid for GenCorp (they stand to receive at least a $78 million profit after GenCorp arranged to buy back its own shares).

* * *

You have heard and will surely hear in the future from a number of corporate raiders about the so-called virtues of "junk bond financing" and how such financing is being used increasingly by small and mid-sized mainstream companies to enable them to secure funds for necessary corporate expansion.

Such comments miss the mark. I do not object to the issuance of low grade, junk securities generally. What is objectionable is the specific use of such financing which permits takeovers to be completed without the raider having to put up any of his own money, with the costs of acquisition being financed by the target company's own assets.

Sincerely,

Andy Sigler

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM DONALD C. CLARK

2700 Sanders Road
Prospect Heights, Illinois 60070
(312) 564.3663

HOUSEHOLD INTERNATIONAL

D. C. Clark
Chairman of the Board and
Chief Executive Officer

April 3, 1987

Senator William Proxmire
United States Senate
Committee on Banking, Housing
and Urban Affairs
Washington, D.C. 20510-6075

Dear Senator Proxmire:

I am pleased to provide the following answers to the supplemental questions that accompanied your letter of March 26, 1987.

Supplemental Question 1:

One of the problems with the 20-day period in which tender offers must be held open appears to be that it is too short for shareholders to have enough time to adequately analyze complex offers. Do you agree with that assessment? Are there other reasons why that period is too short?

Answer

Yes, I do agree with that assessment. In my testimony on March 4, 1987, I recommended that the tender offer period be extended from 20 to 90 days. That longer period would permit a corporation to effectively respond to the simplistic notion that the offer of a premium over current market is all that shareholders need be concerned with--is all that they need to know to determine whether the price is a full, fair price. A 90-day tender offer period would enable the target corporation to call a special meeting of its shareholders so that the raider's tender offer price could be thoroughly reviewed, discussed and voted upon. This extended time would therefore give the shareholders an opportunity to knowingly decide whether the offered price was in their, and in the corporation's, best interest. During the extended period, management could more effectively seek other bids and even consider self-liquidation.

Supplemental Question 2:

The Williams Act does not require that shares be purchased by tender offer, even if the purchaser is seeking to buy enough shares to give him control of the company. I understand that, given today's market conditions, it is possible for someone to accumulate a controlling interest merely by open market purchases of stock, or by purchasing blocks held by arbitrageurs or institutional investors in privately negotiated transactions. Has this created unfairness to shareholders or other problems to which the Congress should address itself?

Answer

In my opinion, the large scale open market purchase programs to which you refer, together with court decisions* sanctioning such programs, have created a major loophole in the Williams Act. These programs circumvent the objectives of disclosure, equal treatment and procedural fairness imposed by the Williams Act and the SEC's tender offer rules. This is particularly true when the open market purchase program occurs during or following a tender offer in that the tender offer typically stirs up the market and puts additional pressures on shareholders. I therefore endorse, as a minimum, the prohibitions on open market purchase programs during or after a formal tender offer, as set forth in the SEC's concept release on takeovers and contests for corporate control (REL. No. 34-23486).

I however believe that the protections suggested in that concept release should apply to any rapid, substantial open market purchase program. In a typical accumulation program, the raider first seeks to exploit the 13D Window, accumulating as much stock as possible through obscure corporations and partnerships designed to keep the raider's identity, purposes, plans and financial capability secret until the last possible moment. Public announcement of a large position then puts the target company "in play", in many cases almost to the same extent as a formal tender offer, resulting in more shares flowing to arbitrageurs and other market professionals and more shares thus being readily available for further accumulations.

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*Hanson Trust v. SCM and Crown Zellerbach

In my judgment, The Williiams Act in not defining "tender offer" evidenced an intent to leave flexibility in the concept of what constitutes a tender offer. It therefore seems that Congress viewed a tender offer not as a definable procedure--a particular means of buying shares--but rather as a process--the process of purchasing control of a public corporation on an expedited, wide scale basis. Accordingly, the Williams Act safeguards should be as applicable to wide scale open market purchases as they are to tender offers. I would propose that any acquisition within a 90-day period of 5% or more of a class of equity securities of a 1934 Act registered company be permitted only by a conventional tender offer complying with Williams Act safeguards. Certain exceptions to this rule would be appropriate. The rule would not apply to acquisitions of stock from the issuing corporation, acquisitions of stock by an employee benefit plan or pension fund of the issuer that are not part of a going private action, and intra-family transfers.

Once again, I very much appreciate having had the opportunity to testify in your hearings on these issues.

Very truly yours,

Donald C. Clark

DCC:n

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

W. R. HOWELL

Q. What do you believe to be the proper role of the states in connection with corporate control contests? Do you believe that the trend of decisions being rendered by the Courts, holding state laws unconstitutional in this area, has adverse public policy considerations and, if so, please explain your views in this regard. Do you think Congress should address this issue?

A. State legislatures and state courts have played the leading role in regulating internal corporate governance. In our view, state legislation in this area is supported by strong public policies, even when such legislation has some effect on takeover contests. The Supreme Court recognized many of these policy concerns when it upheld the Indiana Control Share Acquisition statute in CTS Corp. v. Dynamics Corp. of America, No. 86-71, slip op. (U.S. April 21, 1987), apparently reversing a recent trend of court decisions striking down state laws in the corporate control area. The CTS Corp. decision, in our view, strikes an appropriate balance between state and federal law in this area. Accordingly, we do not believe that Congress need address the issue of state legislation in this area at this time.

Until the Supreme Court's ruling in CTS Corp., recent federal court decisions seemed to have lost sight of the significant and established role of state law in preserving a proper balance among the various groups interested in the outcome of a contest for control.

Rather, the courts -- almost reflexively -- struck down any state law that could colorably be characterized as interfering with the success of a tender offer. This development raised a number of important public policy concerns about the proper relationship of state and federal law in corporate control contests, many of which were recognized by the Supreme Court in CTS Corp.

Tender offers involve purchases and sales of securities traded in our national securities markets and, therefore, fall within the types of transactions traditionally regulated by the federal securities laws. However, they also effect fundamental changes in the ownership and control of target companies. As such, they are closely related to the types of transactions -- such as mergers -- that traditionally have been regarded as an appropriate subject for state corporate laws.

"Congress has never indicated that the entire corpus of state corporation law is to be replaced" by the federal securities laws.[1] Rather, a dual regulatory scheme was contemplated, in which the federal and state authorities share responsibility, each operating within their respective spheres of traditional authority.

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[1] Burks v. Lasker, 441 U.S. 471, 478 (1979).

A fundamental role for states in corporate life has always been partially premised on "the fact", as noted by the Court in CTS Corp., "that state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." Slip op. at 18. The regulatory sphere of state interest in the "internal affairs" of state chartered corporations also has been noted in other decisions by the Court:

> Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.[2]

Corporate governance involves a balancing of rights and duties among directors, managers and shareholders, and it is state law that has traditionally assured that shareholders were treated fairly in transactions involving a change of control. Accordingly, state "corporate law has traditionally protected shareholders' rights by regulating the techniques of effecting change in the corporation's structure, such as the transfer and voting of shares, shareholder agreements and voting trusts, mergers, dissolutions, and the use of proxies."[3] The Supreme Court emphasized the importance of the states' role in this regard in CTS Corp., stressing the long-standing nature of state laws in this area and the states' legitimate interest in continuing to regulate such issues. See slip op. at 14-22.

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[2] Cort v. Ash, 422 U.S. 66, 84 (1975).

In the 200 years of corporate governance in America, the states have developed a comprehensive and balanced body of laws and extensive expertise in regulating the substantive and procedural aspects of corporate governance, including control matters. In contrast, the federal government has developed a body of law and expertise in this area that relates primarily to disclosure in such transactions, and to certain other discrete aspects of tender offers. For example, the structure of the board of directors and the power of the shareholders to remove directors are matters exclusively of state law, although those laws have a significant impact upon the ability of a tender offeror, after acquiring a majority of stock in a company by tender offer, to seize control of the internal corporate machinery. Nevertheless, those laws were thought to be clearly constitutional. The trend of judicial decisions before CTS Corp., however, threatened to render these statutes unconstitutional, since the principles under which the federal courts were routinely striking down state laws in this area might well have applied to other state laws which have the effect of making more difficult the successful takeover of any company by tender offer. The Supreme Court recognized and rejected this possibility in CTS Corp., writing that "[t]he longstanding prevalence of state regulation in this area suggests that, if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly." Slip op. at 15-16.

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[3] Sargent, On the Validity of State Takeover Regulation, 42 Ohio L.J. 689, 724 (1981).

In addition to the specific requirements imposed by statute, states have regulated corporate governance matters by allowing judicial review of corporate conduct. Courts have considerable powers in this area through application of standards of conduct applicable to directors, management and shareholders.

By playing a role in corporate control transactions, the states continue to provide a valuable opportunity for experimentation with different modes of regulation. Finding the proper balance between the competing interests affected by corporate takeovers poses an extremely difficult regulatory problem. And, as Justice Brandeis cogently observed over fifty years ago: "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[4] By permitting the states a role in this area, Congress obtains the benefit of the states' experiences in the continuing effort by both the federal and state governments to achieve a fair and efficient system of corporate and securities regulation. Moreover, because "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations", there can be no undue burden on interstate tender offers caused by any need to comply with numerous different state regulatory schemes; each target company would be subject only to the corporate laws of its state of incorporation. CTS Corp., slip op. at 18.

Not only do the states provide valuable laboratories for experimentation, they also can react more quickly than the federal government to changes in the tender offer process. The techniques used in takeover fights are constantly changing. The state legislatures are often able to react more quickly to emerging problems than the federal government, and are thus better able to address such problems as they emerge in the takeover arena.

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[4] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

Finally, the states have a number of legitimate public policy interests in regulating the internal affairs of their corporations. As recognized by the Court in CTS Corp., "[a] State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs." Slip op. at 20. This not only protects shareholders, but also enhances investor confidence in the fairness and effectiveness of the state's corporate laws. The state also has an interest in corporations that make a substantial contribution to the life of the communities in which they exist. Corporations provide a crucial tax base for the state, goods and services for local, as well as external, markets, and important sources of employment. Naturally, the extent of the state's interests in a corporation will vary from case to case, but these are real interests; they derive from the corporation's reality as an economic entity, not from any formalistic conception of the corporation as a creature of the state. By invalidating state corporate control statutes, the federal courts disregarded these legitimate interests seemingly in favor of an economic theory that encourages tender offers of all types in all circumstances. In CTS Corp., the Court found that such a theory was not binding on the states and noted the "divergent views in the literature" on the theory's validity. Slip op. at 21, footnote 13.

To sum up, the trend of judicial decisions until CTS Corp. was to strike down state laws affecting takeovers, without giving proper weight to the state interests involved. However, the Supreme Court's CTS Corp. opinion seems to have gone a long way towards restoring these interests to their proper place as "an accepted part of the business landscape in this country." CTS Corp., slip op. at 20. In our view, the CTS Corp. decision has restored the appropriate balance between state and federal law in corporate takeover regulation. We thus believe that Congress need not address this issue at this time, but should instead permit the courts an opportunity to react to this decision and refine their views accordingly.

Q. We hear a great deal about the increase in corporate debt resulting from hostile takeovers, but how much has corporate debt in fact increased and to what extent, if at all, is the leveraging of corporate America a problem? To what extent is this related to the recent takeover and leveraged buyout phenomenon?

A. The short answer to this question is that corporate debt is up alarmingly; that, in our view, a good deal of the increase is related directly or indirectly to the mushrooming number of takeover efforts; and that increased corporate debt is a potential time bomb. We believe the remedy for the artificial increase in debt is not found in arbitrary limitations on firms' capital structure. Rather, because increased debt is largely a by-product of a takeover industry that has gotten out of control, the problem is best handled by taking the enormous profits out of putting companies "in play." When the takeover frenzy ends, the takeover-induced debt frenzy will end as well.

The facts are clear. Between 1980 and 1986, the total debt of nonfinancial corporations in this country rose 90%, from 1.336 trillion to $2.535 trillion.[1] During these years, one group of companies has borrowed heavily to make acquisitions, while others have gone deeply into debt to preserve their independence by purchasing their own stock. An example on the acquiror side is Socal borrowing $12 billion to buy Gulf. On the target side, CBS borrowed nearly $1 billion to buy back stock to defend against Ted Turner; Phillips borrowed $4.5 billion to keep Boone Pickens and Carl Icahn away; Union Carbide borrowed $2.2 billion to defend itself against GAF; Unocal borrowed $4.4 billion to defend itself against Pickens; and Atlantic Richfield borrowed $5.2 billion to protect itself against even the prospect of dealing with Pickens or one of the other raiders.

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[1] See annexed chart.

These six examples, which involve $29.3 billion in borrowings, are illustrative of a broader trend. According to the investment banking firm of Salomon Brothers, Inc., in the first 11 months of 1986 some 233 companies bought back, or announced plans to buy back, an estimated $36 billion of their own stock to reduce their vulnerability to takeovers. "'There is reason to believe that reorganization activity will be even higher for all of 1987 than it was in 1986,' Salomon Brothers said in its recently published 'Prospects for Financial Markets in 1987.'"[2]

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[2] Wayne, "1986's Legacy: Tumultuous Era for Big Business," New York Times, December 29, 1986.

Leveraged buyouts -- which are often used to thwart takeovers -- have also increased dramatically. According to statistics compiled by W.T. Grimm & Co., the total annual dollar value of all "going private" transactions, primarily leveraged buyouts, rose from less than $1 billion in 1980 to $7 billion in 1983, almost $11 billion in 1984 and over $24 billion in 1985.[3]

Of equal concern is the type of financing that these borrowers are getting. More and more, raiders and defenders are turning to junk or high risk bonds. Junk bonds accounted for less than 1% of financing for tender offers during 1981-1984, but for 29% of such financing in 1986, almost double the percentage for 1985.[4]

Recent reports by the Congressional Research Service and the Investor Responsibility Research Center confirm that over $100 billion in junk bonds were outstanding by September 1986, with perhaps as much as 38% of them having been issued in connection with hostile acquisitions or takeover fights. Other estimates indicate that as much as 75% of the junk bonds being issued are used in the acquisition or restructuring of companies.[5] Because of the high yields and the highly leveraged nature of many of their issuers, junk bonds pose a serious risk of widespread defaults in an economic downturn. Although junk bond default rates have historically been about 1.5%, during the first half of 1986 that figure rose to 2.7%. No one knows what the default rate would be in the event of a recession. We attach a recent Fortune Magazine study that predicts that as much as 5.5% of junk bonds may suffer a default in the event of a recession.[6]

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[3] Mergerstat Review 1985, W.T. Grimm & Co., pp. 118-19.

[4] Investor Responsibility Research Center, "Junk Bonds and Tender Offer Financing," January 1987, p. 17.

The excessive use of junk bonds also has contributed to the overleveraging of American industry. The number of AAA rated industrial bond issues by corporations and utilities has declined from 56 to 27 in the last decade, while the percentage of below-investment grade bonds issued rose from 9% to 21% of corporate debt.[7] SEC Chairman Shad has bluntly warned that, "The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow." Federal Reserve Board Chairman Volcker has noted the problem caused when takeovers create more debt and less equity in financial structures. He observed that firms which rely heavily on borrowing to complete a takeover may be particularly vulnerable to a downturn in earnings or increases in interest rates.

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[5] "Predators High on Junk," Financial Times of London, January 13, 1987, Section I, p. 20.

[6] It is important to note that most default statistics gloss over instances where issuers come perilously close to default and manage to work out some type of new deal with investors. These include such "solutions" as a company asking its bondholders to accept new bonds that carry a lower interest rate, or permit payments to be made in stock rather than cash. "The Coming Defaults in Junk Bonds," Fortune, March 16, 1987, p. 26. Taking these temporary measures into consideration, the total default rate is closer to 6%. "Debt in the Danger Zone," Business Week, August 4, 1986, p. 23.

The increase in debt, particularly short-term debt, has led to an increase in the number of downgradings of corporate debt issues. Frederick H. Jensen of the Federal Reserve Board's Division of Research and Statistics has estimated that one quarter of the downgradings in 1984 and 1985 was in response to the increased leverage of firms involved in mergers or other corporate restructuring (see Recent Developments in Corporate Finance, November 1986 Federal Reserve Bulletin).

The effect of increased debt incurred to fend off hostile takeovers is illustrated by the experience of Unocal Corp. and Phillips, both of which incurred huge debt in fighting off Mr. Pickens. Unocal's interest expense more than tripled, from $37 million in the first quarter of 1985 to $124 million in the first quarter of 1986.[8] As a result, the company's debt rating has plummeted and, with the decline in oil prices, the company was unable to meet the debt reduction payments it had scheduled.

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[7] "Deep in Hock," The Wall Street Journal, February 2, 1987, at 1.

Phillips' debt swelled to $8.6 billion after it adopted a recapitalization plan to fend off Messrs. Pickens and Icahn. It has sold off over a billion dollars in assets to help reduce its debt, cut its work force and greatly reduced its exploration spending, which will likely place it at a competitive disadvantage with other companies when the oil industry recovers.[9]

When the economy is strong, many companies are able to handle their increased debt. An economic downturn will, however, inevitably cause the failure of some of the corporations that have incurred huge debts in order to fight the current takeover wave. Any large scale repudiation of this debt likely would send shockwaves through the financial community and the economy as a whole.

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[8] "Heavy Debts Weigh on Unocal, Phillips," The Wall Street Journal, July 28, 1986, p. 6.

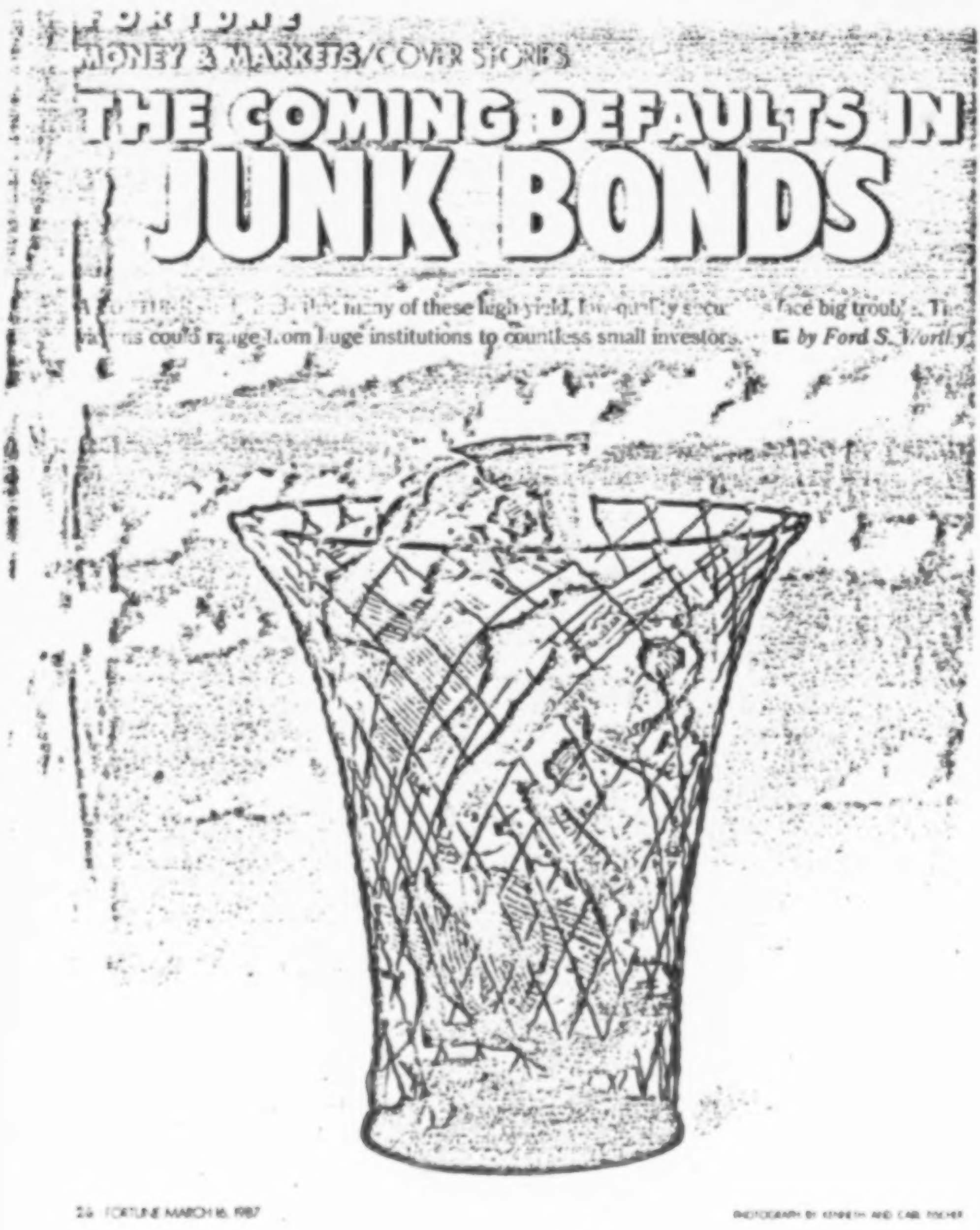
[9] Id.

Congress can and should solve the debt problem by dealing with its fundamental cause -- a takeover frenzy fueled by rules that make takeover attempts easy to accomplish and enormously profitable. Perhaps, as Senator Proxmire suggests, an acquiror should have some personal financial stake in the proposed acquisition in order to dampen speculation and restrict the "takeover game" to those seeking long-term performance rather than short-term profits.

NONFINANCIAL CORPORATE BUSINESS OUTSTANDING DEBT (billions of dollars)

	DEBT INSTRUMENTS	BANK LOANS	OPEN MARKET PAPER & OTHER LOANS	TOTAL DEBT
75	545	169	49	763
76	587	171	61	819
77	657	191	76	925
78	740	226	91	1,058
79	835	270	114	1,219
80	914	296	126	1,336
81	1,019	339	153	1,512
82	1,089	379	151	1,619
83	1,151	400	163	1,715
84	1,345	477	213	2,034
85	1,514	515	247	2,276
86	1,696	568	251	2,535
80-86				1,199

Source: Federal Reserve flow of funds accounts, JCPenney



FORTUNE

MONEY & MARKETS/COVER STORIES

THE COMING DEFAULTS IN JUNK BONDS

A FORTUNE [illegible] that many of these high-yield, low-quality secur[illegible] face big trouble. The vi[illegible] could range from huge institutions to countless small investors. ■ *by Ford S. Worthy*

26 FORTUNE MARCH 16, 1987

PHOTOGRAPH BY KENNETH AND CARL FISCHER

LEVINE. Boesky. Siegel. Wall Street's gallery of rogues keeps growing, with every indication of more to come. But while the financial community waits nervously for the next insider trading scandal to break, another kind of shocker is brewing. Not as dramatic, perhaps—no one is likely to be led off in handcuffs—but with effects that ultimately could prove more far-reaching. The threat: an unprecedented level of defaults by the companies issuing junk bonds.

The fallout might rain down even on people who have never heard of these risky high-yield securities. Hundreds of institutions that have loaded up on the bonds could lose money, ranging from insurance companies to savings and loans. So could thousands of small-time investors who have bought shares in junk bond mutual funds. Undermine investors' confidence in junk bonds and you strike at the heart of Drexel Burnham Lambert, whose senior executive vice president, Michael Milken, pioneered their use and revolutionized corporate dealmaking in the process. Put a crimp in the ability of takeover artists to raise financing by selling junk bonds through Drexel or other investment banking firms, and the acquisition game slows down. Fewer companies will be menaced into restructuring, including some that still need to.

True, critics of junk bonds have been prophesying an imminent, cataclysmic wave of defaults for years (the sky is falling, the sky is falling). And true, despite the predictions, this high-yield corporate bond market has merely steamed ahead, proving amazingly resilient when bumps did occur. It bounced back after two jolts in 1986. In July, LTV, the giant steelmaker, went into Chapter 11 and stopped payment on bonds with a face value of $2.1 billion, the biggest junk default ever. Then came the revelations last November that Ivan Boesky, a big Drexel customer, had connived in illegal insider trading and was now cooperating with government investigators in search of other malefactors. Prices of junk plummeted after each debacle, but rebounded impressively, enabling the overall market, as measured by a Drexel Burnham index, to sport a healthy 15% total return for the year.

This time around it may be different. FORTUNE has made one of the first comprehensive attempts to find out how shaky the junk bond market really is. The answer: not as bad as some Chicken Littles have been saying, but much more worrisome than the defenders of junk would have us believe. The market for junk bonds won't collapse, but it could be rocked to its foundations.

In an effort to gauge the potential problem, FORTUNE enlisted the help of Houlihan Lokey Howard & Zukin, a Los Angeles consulting firm nationally known for its work in analyzing the solvency of companies. The firm scrutinized a universe of about 500 companies that altogether had junk bonds with a face value of $72.5 billion outstanding at the end of 1986. Studying these, it identified 36 companies whose bonds, with a face value of $4 billion, seem particularly vulnerable. Looked at another way, some 5.5% of the junk bonds in our sample appear to be vulnerable. At first glance, 5.5% might not appear that threatening. Look again: It's over three times the historical rate of default for publicly traded junk bonds, around 1.5% a year, which Drexel and others have harped on in touting the securities.

Put a crimp in the ability of takeover artists to raise money with junk bonds, and the acquisition game slows down.

These atomic bonds, as Houlihan Lokey calls the riskiest of them, are not necessarily destined to blow up or melt down. Many of the companies that issued them will undoubtedly find ways to survive: by bringing in new management, selling assets to repay debt, winning concessions from lenders, or selling out to stronger companies. Indeed, Drexel officials, who have expressed disdain for FORTUNE's project, say that the prospects for many of the companies listed here are so good that savvy investors would do well to view them as buying—not selling—opportunities. *Caveat emptor.*

To understand the danger that junk bonds present now, you have to understand the nature and history of the beast. The two major bond-rating agencies refer to junk securities—those rated BB+ or below by Standard & Poor's, or Ba1 or less by Moody's Investors Service—as "speculative grade." Drexel prefers the appellation "high yield." By any name this is the riskiest of all marketable corporate debt. But the spectrum of risk within the junk market is incredibly broad. For example, B.F. Goodrich Corp. junk bonds currently yield about 9% a year, an indication that investors regard them as much less risky than certain Bethlehem Steel bonds, which if bought today and held to maturity would, God willing, yield nearly 17%.

Junk bonds represent about $145 billion of the $550-billion totality of all corporate bonds. Approximately $125 billion of junk is what's called straight debt, bonds whose holders receive regular fixed-interest payments, typically every six months, until maturity, when the principal is repaid. Holders of convertible debt (about $20 billion outstanding) have the option to exchange the bonds for other securities—usually common stock. About a third of all junk bonds are "fallen angels" that began life with investment-grade status and grew riskier as the issuer's fortunes declined. The other two-thirds were junk from day one.

The market for junk has grown wildly—from about $1.5 billion worth of lesser-quality bonds issued in 1978 to $7.4 billion in 1983 to $48 billion last year—largely because of the super-salesmanship of Drexel's Milken, the preeminent figure in corporate finance today. From his offices in Beverly Hills, Milken convinced investors that the expected yield on a diversified portfolio of junk bonds overcompensated them for the risks entailed. Such bonds are bought and sold mostly on the basis of the spread between their yield and the yield on risk-free government bonds. A typical junk bond portfolio yielding, say, 11%, currently enjoys a spread of about four percentage points over the 7% yield investors can earn on government bonds of similar maturity. In theory the spread owes to the likelihood that the junk portfolio will suffer losses over time, for instance as individual bonds default.

MILKEN'S GENIUS was to recognize that in any year only a tiny percentage of companies issuing such bonds had failed to make an interest or principal payment on time. Moreover, bonds that do default lose only a portion of their value. As long as history repeated itself, an investor with a diversified portfolio of junk could expect his total return to be reduced by default losses of just one percentage point a year. Junk bonds seemed to promise free money, Milken and his fellow Drexel salesmen told their clients, because even after subtracting expected default losses, total returns from junk would be far higher than risk-free Treasury bonds.

REPORTER ASSOCIATES *Lorraine Carson, Christopher Knowlton, Tricia Park, Andrew Evan Serwer*

Portfolio managers for insurance companies, pension funds, and mutual funds quickly caught on and poured money into the high-yield sector as never before. Everything else being equal, the flood of new money should have caused the interest rate spread between junk bonds and government bonds to narrow. Instead—and ominously—when interest rates on Treasuries and high-grade corporates began to fall a couple of years ago, yields on junk held steady. The wider spread was the market's way of saying that junk was getting trashier.

In their rush to invest, some institutional money managers skipped the exhaustive research that they customarily perform before buying risky issues, relying instead on the strength of the underwriter's endorsement. Many simply didn't have a sufficient number of qualified analysts to thoroughly screen the hundreds of new issues coming onto the market or to closely monitor the scores of issues already in their portfolios. In addition, junk issuers and their bonds proved to be

Too Hot to Handle?

While these junk bond issuers are the shakiest in our sample, they aren't all going to default. Some will scrape by, perhaps with the sort of exchange offer Drexel Burnham has pioneered for clients. Total debt includes bank debt.

ATOMICS

COMPANY	PRIMARY UNDERWRITER	DEBT/ EQUITY RATIO	TOTAL JUNK BONDS in millions	TOTAL DEBT in millions
Allegheny Beverage	Smith Barney	5.9	$192	$381
American Healthcare Management	Drexel Burnham	12.8	$80	$435
Cannon Group	Drexel Burnham	7.8	$243	$596
Care Enterprises	Drexel Burnham	4.2	$68	$179
Compact Video	Drexel Burnham	3.9	$80	$174
Consolidated Oil & Gas	None	14.8	$42	$104
Consul Restaurant	Piper Jaffray	3.7	$21	$26
Lifestyle Restaurant	L.F. Rothschild	2.9	$12	$16
Michigan General	Drexel Burnham	5.6	$110	$146
Pay 'N Save	Drexel Burnham	3.5	$295	$343
Pennsylvania Engineering	None	10.9	$12	$86
Penril	Drexel Burnham	3.2	$18	$35
Po Folks	Kidder Peabody	4.4	$16	$75
Pope Evans & Robbins	Bear Stearns	2.8	$35	$39
Preway	Drexel Burnham	10.3	$56	$60
Quanex	Drexel Burnham	2.5	$103	$112
Reading & Bates	Smith Barney	5.1	$60	$486
Spendthrift Farm	Prudential-Bache	3.7	$30	$44
Texas International	Drexel Burnham	2.8	$190	$298
Thousand Trails	Prudential-Bache	6.9	$57	$188
Wean United	None	3.6	$27	$37
Western Union	Salomon Brothers	3.9	$526	$924
Westworld Community Healthcare	Drexel Burnham	15.2	$65	$123
Winners	Prudential-Bache	3.5	$25	$49

Atomics

COMPANY	PRIMARY UNDERWRITER	DEBT/ EQUITY RATIO	TOTAL BONDS OUTSTANDING in millions	TOTAL DEBT in millions
Arrow Electronics	Bear Stearns	2.2	$110	$164
Ducommun	Donaldson Lufkin	2.8	$35	$160
Kaneb Services	Smith Barney	2.0	$55	$125
Kay	Bear Stearns	3.1	$10	$165
Lear Petroleum	Drexel Burnham	6.5	$196	$266
MCO Holdings	Drexel Burnham	4.5	$81	$327
Price Communications	Morgan Stanley	3.4	$375	$447
Radice	E.F. Hutton	3.3	$34	$168
Service Merchandise	Merrill Lynch	3.6	$300	$904
Texstyrene	Drexel Burnham	2.3	$50	$82
Universal Health Services	Morgan Stanley	3.0	$85	$333
Valero Energy	Shearson Lehman	3.4	$277	$897

Handle With Care

A little less risky than atomics, the subatomic bonds of these companies still need to be approached with caution. Like the atomics, they're vulnerable, not necessarily doomed. Virtually all bonds outstanding are junk grade.

complex creatures that sometimes didn't lend themselves to analysis with traditional financial models. An executive at one rating service says that more than a third of the money managers he advises don't do any independent research on the bonds they buy.

HAD THEY DONE their homework, they might have been wary of that low historical default rate. To begin with, the default rate for publicly traded junk debt—which averaged 1.5% annually for the period 1974-86, according to New York University finance professor Edward Altman—is based in part on years when the total amount of junk was paltry by today's standards. Nearly two-thirds of all outstanding junk bonds were issued in just the last three years, roughly half in the last two years. As Altman notes, it generally takes a few years for even the worst junk to spoil, so the most recently issued stuff hasn't had a real chance to affect default rates. Nor has the junk of recent vintage had to weather a downturn in the economy.

More important, the nature of the bonds in the market appears to have changed significantly in the past few years. In 1986 an estimated $12 billion in new junk bonds—roughly 25% of all the junk issued—was sold in connection with leveraged buyouts, those extra-risky transactions where new owners essentially hock a company to buy it. In previous years LBO-related bonds represented such a small portion of the market that nobody bothered to keep statistics on them. It's not uncommon for LBOs to have nine parts debt for every one part equity, a recipe that few companies can live with for long. The people who do LBOs count on being able to swiftly pay down that debt by selling off some of the company's assets. "Everybody in an LBO deal is going for a quick home run," says a New York banker. Lots of junk owners could go down swinging if a recession slows down that resale market.

Most default statistics also fail to take into account instances where issuers come within an eyelash of bankruptcy before some sort of rescue mission saves them. Among the most common rescue operations is the exchange offer: A company gives its bondholders new securities in exchange for the old bonds. A company out of cash and on the brink might ask its bondholders to accept new bonds that carry a lower interest rate, or permit interest to be paid in stock rather than cash. Says Ray Minella, who runs Merrill Lynch's high-yield operations: "Most such exchange offers are bankruptcies without the benefit of a judge."

James A. Schneider, a Drexel executive and an expert on exchange offers, says that the idea is to give the ailing company enough time to get to a "better doctor"—an outside investor, perhaps, who's willing to give the company a big infusion of equity. If the patient goes on to survive, the investors who hang on to the bonds can do quite well. But many investors choose to sell out, often at prices less than 50% of the face value of their bonds. That's so close to what bonds sell at

ILLUSTRATIONS BY STEVEN GUARNACCIA

just after defaulting—typically around 40% of face value—that some analysts refer to emergency exchange offers as "soft defaults." But these soft defaults don't show up in the historical rate.

The historical rate of default nonetheless continues to be the centerpiece of the case that Drexel and others make for junk bonds as a safe investment. Says Larry Post, Drexel's co-head of high-yield bond research: "Unless you think the overall credit quality of the market has gone down, there is no reason to believe that default rates in the future won't be similar to those of the past."

But that larger spread between junk and high-grade bonds suggests that the overall credit quality *has* gone down. Other evidence points the same way. For instance, the proportion of new junk bond issues landing in Standard & Poor's or Moody's lowest-rated categories or going unrated has increased from 6.3% of new issues in 1980 to over 40% last year, according to IDD Information Services, a research firm.

No one has a perfect formula to measure the risk that a company will default on its debt. S&P and Moody's, in making their judgments, consider a broad range of financial data reflecting both the company's past performance and management's projections for the future. They also make more subjective assessments: How sound is management? How likely is potential litigation against the company?

WHILE those judgments may be quite valuable, FORTUNE asked Houlihan Lokey to devise a more rigidly objective series of measures to spot especially vulnerable companies. The approach that resulted relies heavily on how the marketplace values a company's stock. Says Marko A. Budgyk, the Houlihan Lokey analyst who developed and managed the study: "We believe that by looking at a company's stock price, you can get a very accurate reading of how investors perceive the company's prospects. In effect, you've got a million different investors telling you what they think of management, of that potential strike on the horizon, of that new product the company intends to conquer the world with."

Houlihan Lokey combed through both Standard & Poor's and Moody's bond guides for January, identifying companies with at least one straight or convertible bond outstanding that either agency rated as junk. From that sample of 792 companies, representing $125 billion in junk, it eliminated firms whose $33 billion of junk bonds are publicly traded but whose common stock is not. The study also excluded electric utilities, representing $11 billion in bonds, and banks and other financial services compa-

Sunken Junk

The junk bonds of these companies have defaulted since January 1, 1986, and remain in default. Note the absence of Drexel Burnham among the underwriters; it rescues many clients before default.

DEFAULTED COMPANIES

COMPANY	PRIMARY UNDERWRITER	TOTAL BONDS IN DEFAULT in millions	TOTAL DEBT in millions
Argo Petroleum	Shearson Lehman	$25	$66
Chapman Energy	Thomson McKinnon	$22	$45
Digicon	Paine Webber	$55	$113
ICO	Prudential-Bache	$30	$45
Kenai	Offerman	$73	$77
LTV	Merrill Lynch	$2,100	$2,800
McLean Industries	First Boston	$243	$1,089
Smith International	Morgan Stanley	$75	$495
Texas American Oil	E.F. Hutton	$25	$38
Towle	Salomon Brothers	$25	$68
Wedtech	Bear Stearns	$115	$140
Western Co. of North America	Smith Barney	$58	$574
Zapata	Shearson Lehman	$78	$663

nies, another $9 billion. Both have characteristics that make comparisons with industrial and nonfinancial service companies of little value. Finally, there was no way to assess junk bonds issued in private placements, a category that represented $23 billion in new issues over the past two years, according to Merrill Lynch.

Houlihan Lokey next evaluated the remaining junk bond issuers in terms of three market-based criteria: the total market value of the company's stock and equity equivalents, the volatility of its stock price, and its leverage. The analysts calculated each company's leverage, dividing total debt by the market value of the equity. Total debt figures were based on the most recent quarterly financial statements. For the equity part of the ratio, Houlihan Lokey used the market value of each company's equity on January 30. FORTUNE subsequently asked each company to confirm its debt and equity figures; if a company reported significant changes on its balance sheet since its last financial statement, we used the fresher numbers.

AS A COMPANY'S leverage increases, its ability to service its debts usually declines and the risk of default rises. In the view of Houlihan Lokey and most other experts, big companies, with more equity outstanding, are able to tolerate higher leverage than their smaller counterparts. Small companies—those with equity of less than $100 million—were considered vulnerable if their debt-to-equity ratio exceeded 2.5 to 1. Companies with between $100 million and $250 million in equity were considered vulnerable if their leverage was more than 3 to 1. For companies with equity of $250 million to $500 million, the cutoff point was 4 to 1; for companies larger than that, 5 to 1.

To show up on the final lists, a company with that high leverage had to meet yet another test. Houlihan Lokey took a reading of the relative stability of each company by measuring the price volatility of its common stock over the preceding six months. The higher a company's volatility, the greater the daily changes in how investors expect it to perform in the future. In general, companies with high volatility are perceived to be riskier than companies with low volatility.

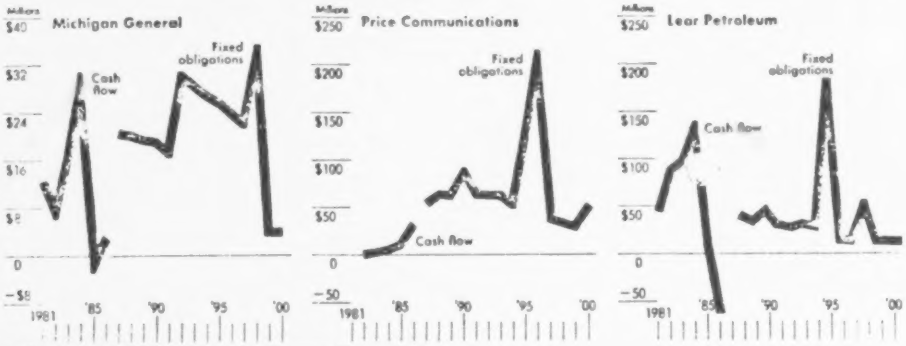
What emerged from this sifting and resifting were 24 "atomic" companies whose junk bonds are highly vulnerable to default. Twelve others, either not so highly leveraged or not so volatile, were judged by Houlihan Lokey as slightly less risky, but sufficiently dicey to qualify as "subatomic." Again, this does not necessarily mean that the companies are going to default. But they do appear to face substantially higher risks than their peers within the world of

QUALITY JUNK

COMPANY	PRIMARY UNDERWRITER	DEBT/ EQUITY RATIO	TOTAL JUNK BONDS in millions	TOTAL DEBT in millions
Caesars World	Drexel Burnham	0.8	$232	$495
Castle & Cooke	Goldman Sachs	0.4	$173	$455
Circus Circus	Drexel Burnham	0.2	$75	$180
Federal Paper Board	First Boston	0.6	$144	$472
Fuqua Industries	Shearson Lehman	0.5	$159	$311
GAF	Drexel Burnham	0.3	$486	$486
GenCorp	Kidder Peabody	0.1	$103	$208
B.F. Goodrich	Goldman Sachs	0.4	$92	$489
Forer Group	First Boston	0.5	$326	$452
Tele-Communications	Drexel Burnham	0.8	$505	$2,163
Telex	Drexel Burnham	0.1	$21	$106
Texaco	Salomon Brothers	1.0	$6,722	$9,394
United Brands	Drexel Burnham	0.2	$96	$135
Whittaker	Dominick & Dominick	1.0	$44	$268

Top of the Junk Heap

More like investment-grade outfits than junk, these companies have low leverage, low stock-price volatility, and a lot of equity. Indeed, the junk bonds of some of these companies might end up being upgraded.



Where Will the Money Come From?

These spiky graphs compare approximations of each company's operating cash flow over the past five years with the Houlihan Lokey firm's estimates of how much cash will be needed in the future to cover their fixed obligations. These include interest on their debt, the principal as it matures, and dividends on preferred stock. The case of Price Communications illustrates one shortcoming of this kind of analysis: According to its most recent available balance sheet, the broadcasting company has approximately $200 million of cash it could use to pay down debt. The graph doesn't reflect that.

junk. Houlihan Lokey didn't estimate probabilities of default, nor did it predict when default might occur.

The main strengths of the Houlihan Lokey approach stem from its reliance on the information captured in a company's stock price. Larry Post of Drexel has used a similar approach, in fact, in analyzing junk bond issuers for almost ten years. But as Post and others point out, the method has its limitations. For example, debt is sometimes structured so that the issuer can make interest payments in the form of shares of stock during troubled times, thus conserving precious cash. And companies don't make any cash payments on zero-coupon bonds until the bonds actually come due. In such cases, companies may find extraordinarily high leverage quite tolerable.

Houlihan Lokey's method also fails to consider the amount of cash a company has in the bank—"Cash being one of the best ways I know of," Post observes, "to make the interest payment on a bond." The towering pile of cash currently on the books of Revlon Group, a company that narrowly missed the cutoff for subatomics, is a big reason that the bond research firm McCarthy Crisanti & Maffei rates the company as having a mere 2% chance of default in the next two years. But, says Philip Maffei, noting that Revlon is controlled by the acquisitive Ronald Perelman, "you can't assume that all that cash is just going to sit there for the benefit of bondholders." That's why his rating firm believes the possibility of a Revlon default in the next *five* years is closer to 10%.

These important caveats aside, the companies on FORTUNE's list include some real prizes. Even as Houlihan Lokey was doing its initial sorting, Chapman Energy, a Dallas oil and gas company, defaulted on junk bonds with a face value of $22 million. Spendthrift Farm, a Kentucky horse-breeding operation that's an atomic, and subatomic Kaneb Services, an oil services company, both announced that they expect not to make interest payments due later this year. Says Kaneb's vice president, Robert Pando: "That's why they call them high-risk bonds."

NOT SURPRISINGLY, most of the companies listed as atomic or subatomic are working overtime to bolster their balance sheets. In the past year, several have exchanged some of their old bonds for new ones with terms more lenient to them. Others, including Westworld Community Healthcare, are planning exchange offers. Lear Petroleum paid off enough bank debt in early January to transform itself from an atomic company to a subatomic.

Many executives at the listed companies took strong issue with Houlihan Lokey's methodology. Others argued that in going purely by the numbers the study failed to consider important mitigating factors. For example, Valero Energy, a subatomic, plans to spin off its natural gas pipeline operations into a limited partnership, a transaction that the company says will raise $700 million—cash it will use to pay off enough debt to cut its borrowings by more than half. Texas International has agreed to sell $120 million of assets for cash it can use to pay down its debt. An executive at Quanex, an atomic, emphasized that, unlike most junk bonds, its bonds are secured by a lien on two of its steel plants. "At the first default," he says, "the bondholders get the plants."

Who owns the junk that's likely to show up on the next heap of defaults? High-yield mutual funds own about $26 billion in junk, according to Lipper Analytical Services. FORTUNE examined the portfolios of 35 of the 50 or so funds that invest mainly in junk bonds, using the most up-to-date quarterly reports available. Four were too old to consider. The remaining 31 dated from June to December of last year. If atomics and subatomics in a fund's portfolio represented the same proportion as they do of the entire junk universe—including bonds FORTUNE excluded from its sample—then each fund would have about 2.8% of its holdings allocated to these most vulnerable types. As a group, however, the funds appeared to have a slight predilection for the risky stuff. Twenty-four of the 31 funds had more than 2.8% of the total value of their bond holdings invested in atomics or subatomics. The percentage of risky junk varied considerably from fund to fund: In June, Bull and Bear High Yield Fund owned atomics and subatomics with a face value of $20 million, representing about 18% of its $111 million invested in bonds. At the other extreme, Vanguard's High Yield Bond Portfolio, with total bond holdings of $954 million last July, owned atomics and subatomics amounting to only 1.9% of its portfolio.

Besides junk bond mutual funds, few buyers of junk disclose much about what they own. Pension funds, which own an estimated $15 billion in junk, must report their holdings only once a year, and only to the Internal Revenue Service, which doesn't make the information public. Insurance companies ($40 billion) open the kimonos on their portfolios only once a year, in publicly available statements they file with state insurance commissioners. While most statements currently available are too old to matter, FORTUNE checked the December 1985 portfolios of Executive Life of New York and Presidential Life, both well known for investing in junk. They seem to be particularly savvy junk collectors: Both had minuscule holdings of atomics and subatomics. "I don't like the small deals," sniffed an investment officer at one of the companies as he was read the names on FORTUNE's lists.

While a few institutional investors may have portfolios overloaded with the junkiest junk, it seems likely that the riskiest stuff is fairly evenly distributed. If the rest of a money manager's junk bonds perform as well as they have in the recent past, a default rate as high as 6% would knock down the total return on his portfolio by approximately 3.65 percentage points, an estimate based on Professor Altman's studies of how much value bonds typically retain after defaulting. In other words, the return would be reduced to about what he could earn on government bonds.

But *will* the other 94% of junk bonds go on performing as well as always? A 6% default rate would probably shake investors' confidence in a far broader segment of the market. An exodus from junk to higher-quality investments—or from low-grade junk to high-grade junk—could send bond prices tumbling. Even investors perspicacious enough to have avoided the defaulted bonds could see the values of their portfolios shrink, at least until the market regained investors' faith.

A RECESSION could have far more drastic consequences. Most economists say that as long as the economy keeps chugging along they won't worry too much about the junk bond market. But they add that even a modest downturn later this year, a scenario that few economists are predicting, could jeopardize junk issuers in already weak industries such as steel, construction, and restaurants. "Massive failures of companies with junk bonds are a distinct possibility in a downturn," says Edward Yardeni, chief economist for Prudential-Bache Securities. A shakeout, he says, "could feed on itself. Because there are so many companies financed this way, there could be sort of a domino effect."

What seems more likely is the emergence of a two-tier market in junk bonds. Investors and rating agencies, more aware of the vastly different tiers of quality, probably will invent a new line to divide "investment grade" junk from the "speculative" stuff. Drexel's Post, for one, maintains that the amount of independent analysis performed by junk investors has increased "substantially" in the past year. Drexel's competitors, seeking to make a name in the business, are also committing more resources to credit analysis.

There's quality—of sorts—to be had. Over the past two years, as Morgan Stanley's Martin Fridson notes, an impressive number of large, highly liquid junk issues have come onto the market, issued by the likes of BCI (formerly Beatrice), Colt Industries, and Phillips Petroleum. Another encouraging sign: Some issuers are beginning to pay off their junk debt by selling stock. If the stock market stays strong, many companies will have an opportunity to convert some of their debt into equity.

The emergence of big issuers along with scores of midsize but equally solid companies stands to encourage more investors to participate in the junk market. In fact, 15 large insurance companies surveyed recently by Morgan Stanley suggested that they ultimately plan to invest an additional $20 billion in high-yield bonds. That will presumably mean still more credit analysts crunching the numbers.

As more investors join the chase for high yields, the market should grow more efficient. The interest-rate advantage that quality junk bonds have offered compared with high-grade corporates should narrow. Indeed, while more junk bonds than ever before are likely to live up to their name over the next few years, far more are apt to become known by a new, less pejorative label. Blue-chip junk, anyone?

BANKS, TOO, LIKE JUNKY COMPANIES

■ Where there are junk bonds, there are often junk bank loans. Bankers generally don't like to talk about how inextricably connected to the junk bond market they have become. But contrary to the popular perception that companies that issue junk bonds aren't sound enough to borrow from banks, many issuers have apparently had no trouble lining up ample supplies of bank debt. Of course, they also pay a higher rate of interest on their loans than the average corporate customer. In addition to their junk bond borrowings, the companies on our atomic and subatomic lists owe another $5 billion—much of it to banks. Houlihan Lokey estimates that all the junk bond issuers it evaluated in creating the lists together owe close to $200 billion in bank debt.

Bankers insist that *their* loans are "well protected," whatever other defaults may occur. While loans to junk issuers are not generally secured by specific collateral, banks almost always have first claim on a company's assets in the event it goes bankrupt and has to liquidate. The bankers also fill their loan agreements with myriad covenants that give them the right to step in if a borrower starts getting sickly. "I've done deals where I knew my loan could be repaid no matter what kind of trouble the company eventually got into," says a top executive at a major New York bank. As for the bondholders, he adds, "I wasn't so sure they'd see their money back in a bankruptcy situation." For taking that extra risk, of course, junk bond investors earn a higher rate of interest than the banks do on their loans.

There is little indication that banks will want out of the market any time soon. First Chicago, Drexel's lead bank, did catch the junk bond jitters shortly after the Boesky affair broke, telling Drexel that it would no longer accept junk securities as collateral for short-term loans to the same extent it once had. But most banks continue to look at high-risk companies with the same hungry eyes as investors who buy their bonds.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
William L. McKinley

Question: It has been said that the large number of hostile takeovers in recent years has forced corporate managers to concentrate on short-term results at the expense of long-term growth. Do you agree with that?

Answer: Yes. There is constant pressure to show short-term results so as to protect against the "quick fix" raider. As a company, we try very hard to stay long-term in our planning and our activities. We have made substantial commitments, both financial and time, to implement the future growth plan.

We know, however, that it is a risky decision and that stockholders, because of the short time in which to make a decision, have a real problem in deciding whether to stay for the long-term growth or take the quick dollar.

Our own situation in 1977 has proved that the stockholders were best served by remaining with the company, but the pressure was substantial even though under Michigan law (since ruled unconstitutional because of Williams Act preemption) stockholders were given some time to react.

We do not believe cutting research, foregoing plant improvements which make facilities State of the Art, or in various other ways cutting costs necessary to enhance future growth benefit the stockholder, the community, the employees or the general competitiveness of the United States in the international fields in which we compete.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
ROBERT E. MERCER

The Goodyear Tire & Rubber Company

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April 17, 1987

Honorable William Proxmire
Chairman,
Senate Banking Committee
Room 534
Dirksen Office Building
Washington, D.C. 20510

Dear Senator Proxmire,

I appreciate the opportunity to have testified about corporate takeovers at your hearing on March 4. I believe a number of important issues were raised at that hearing, and I applaud your committee for its work.

By your letter of March 26, you have asked that I respond in writing to two supplemental questions. The first question is:

> Some have argued that takeover defenses, such as "poison pills", should be eliminated because, it is argued, they harm shareholders by depriving them of the higher price offered in a tender offer, in order to preserve management's jobs. Furthermore, some say that any reform of the Williams Act should include the elimination of takeover defenses such as "poison pills" in order that our legislation be fairly balanced between bidders and target company management. How do you respond to these arguments?

In my opinion, defensive provisions have been beneficial to target shareholders and definitely should not be eliminated by Congress. When properly used, they have played an appropriate and beneficial role in the takeover process. While no takeover defenses can or should make a target invulnerable to acquisition, they do provide target management a limited opportunity to defend against inadequate and unfair offers and, where appropriate, to remain independent. They also provide targets with some leverage with which to negotiate with takeover bidders, on behalf of the target shareholders, for a higher offering price. As a result, such measures can permit target boards of directors to discharge more effectively their fiduciary duties to their shareholders in the middle of a hostile battle for control.

Several related points support my conclusion: First, takeover defenses have been an important means by which targets have attempted to keep the playing field level. The enormous profits made by raiders against their targets in recent years, the enormous fees earned by investment bankers in successful takeover bids, and the support for takeover activity provided by arbitrageurs and institutional investors all have kept the playing field heavily tilted against targets in takeover bids. The record shows that, without any defenses, the fate of every public corporation would be in the hands of raiders, investment bankers, arbitrageurs and institutional investors, with their short-term perspective. Many companies could be taken over by the first offer that is somewhat above the prevailing market price, even if the inherent value of the company's stock is far greater. I believe it is safe to say that most people would not welcome the disruption and economic dislocation that would occur.

Moreover, many, if not most, takeover defenses have been designed to respond to particular abusive tactics invented by corporate raiders. For example, the development of two-tier tender offers, which even raiders such as Boone Pickens acknowledge can be coercive and unfair to target shareholders, has spawned so-called "fair price" charter amendments which are designed to deter such offers. Fair price charter amendments are a clear case of a defensive measure that has benefited shareholders. In fact, studies show that institutional investors, who often vote against the adoption of defensive measures, do not oppose fair price charter amendments because of their beneficial effect.

Second, the directors' fiduciary duty to shareholders limits any abuse of defensive measures. Critics of defensive measures charge that defensive measures only entrench management. This argument, however, ignores the importance of the directors' responsibility to the shareholders. The poison pill and most other takeover defenses rely upon the board of directors to make decisions in the best interests of the company and its shareholders. Unlike corporate raiders and arbitrageurs, only the board of directors has a fiduciary duty to the company and to its shareholders. And, unlike the takeover players, the board of directors takes into account the interests of the wider community interested in the company's future.

Recent cases in Delaware and elsewhere confirm that, in a takeover context, courts will hold a target's directors to a heightened standard of care; thus, the directors must act in recognition of the very real threat of liability if they fail to meet that standard. Courts generally require that the directors demonstrate, in order to defend their actions under the "business judgment rule", that they acted with due care and deliberation and not for the purpose of maintaining their positions in office. Moreover, to the extent that management entrenchment is a factor, courts will scrutinize the actions of any independent outside directors. Most large corporations today have a majority of independent outside directors, whose jobs are not at stake in the face of takeover bid.

The issue of the desirability of takeover defenses should not focus simply on their adoption. Most defensive measures, including shareholder rights plans, sometimes referred to as "poison pills", and many shark repellent charter provisions, contain "safety valves" which permit the board to disarm a defense in the face of a takeover offer that is in the shareholders' best interest. Because of these safety valves, the courts evaluate not only the adoption of such a measure, but also the directors' decision whether or not to defuse it. In the case of poison pills, courts scrutinize the decision whether or not to redeem the rights (effectively cancelling their defensive effect) in response to a particular offer. If the directors breach their fiduciary duty by refusing to redeem in response to a fair and adequate offer, they could be held personally liable to shareholders, but at the very least the courts will invalidate the rights.

When directors have abused their power in adopting defensive measures, or have applied such measures in an abusive way, the courts have not hesitated to invalidate the directors' actions. While the Delaware Supreme Court upheld the power of the directors to adopt so-called poison pills in a leading case in November 1985, that court stated that the directors' decision whether or not to redeem the rights in the face of a particular takeover bid would be evaluated in light of the directors' fiduciary duty. Before and after that decision, courts have struck down a number of shareholder rights plans -- including most recently those of NL Industries and CTS Corporation -- which were not redeemed by the directors under circumstances where they could not fully justify their actions.

Thus, the real focus of consideration of most defensive measures should be on the circumstances at the time the measure is used or not used in a particular control contest. The issue should not be, as critics of defensive measures would have it, one of whether defensive measures should be permitted at all.

As the foregoing suggests, the evaluation of whether a defense should be permitted under particular circumstances is highly dependent on the particular facts. Even if Congress were to assume the states' traditional role of regulating such matters, it should not make a one-time decision applicable to all cases. And unlike the Congress, the courts are able to evaluate -- and so far have evaluated effectively -- defensive measures on a case-by-case basis.

Third, defensive provisions benefit target shareholders. As stated previously, most defensive measures, including shareholder rights plans and many "shark repellent" charter provisions, contain safety valves which permit the board to defuse the defense in the face of a takeover offer that is in the shareholders' best interest. Because of these provisions, shareholders rights plans and other defenses give the board of directors greater negotiating power to get the bidder to offer a higher price to the shareholders.

The charge that defensive provisions deprive shareholders of the higher price offered in a tender offer is flatly contradicted by the record. In countless cases, adding shark repellents to a target's charter has resulted in raiders' being obligated to pay higher prices or deal fairly with all the shareholders. For example, so-called fair price provisions, which were mentioned above, can help deter abusive practices, such as two-tier tender offers in which some shareholders receive a lower price for their shares than others or in which some shareholders receive an inferior form of consideration (typically debt securities) to that paid at an earlier stage to other shareholders (typically cash). Shareholders rights plans can help accomplish the same thing: many are triggered when the corporate raider undertakes certain specified abusive practices that would harm the shareholders, such as self-dealing and similar transactions.

The track record for shareholders rights plans' benefitting shareholders is well established. In several cases in which directors have redeemed pills, the redemption power has provided the target's directors with bargaining leverage to obtain a higher price for the target's shareholders. For example, in February 1986, Westchester Financial Services was the subject of a hostile bid by Northeast Savings at $30 per share. After Westchester adopted a poison pill, Northeast commenced a tender offer for $33 per share. Three months later, Westchester entered into a transaction with Marine Midland at $53 per share immediately after Westchester redeemed their rights. In May 1986, Ex-Cell-O adopted a poison pill and, almost three months later, received an offer for $68 per share. Ex-Cell-O rejected the offer as inadequate, but later agreed to a revised offer of $77.50 per share.

In other cases, defensive measures that help keep a company independent can ultimately permit it to realize greater value for its shareholders. A recent Kidder Peabody study shows that, of 49 defeated tender offers in a 10-year period, the stock price of 92% of the companies surveyed reached a level (after adjustment for inflation) higher than that of the highest price offered in the tender offer.

Fourth, defensive measures do not stop takeovers. Because directors do in fact redeem poison pills in appropriate cases, and because courts do in fact invalidate poison pills that have been misused or whose provisions are excessively restrictive, many companies that have adopted poison bills have nevertheless been taken over. These companies include Associated Dry Goods, Crown Zellerbach, RCA, McNeil Corp., Eastern, AMSTED Industries, Cluett Peabody, Ex-Cell-O, Safeway, Sea-Land, Westchester Financial Services, Great Lakes International, Revlon, Victory Markets and William E. Wright. No poison pill or other defensive measure can make a company invulnerable to a takeover. If they did, the success rate of raiders in recent years and their resulting profits would not be so high: According to one recent study by Morgan Stanley, hostile bidders are now enjoying a 50% success rate, compared with a previous success rate of approximately 20%

In my view, therefore, Congress should not eliminate takeover defenses. This is true for three reasons. First, Congressional legislation, no matter how sweeping, will not and cannot eliminate all the abuses of corporate raiders. Defensive measures that are designed to respond to the remaining abuses will thus be necessary and appropriate.

Second, even if Congress did successfully eliminate all existing abuses, new ones would be invented by the raiders and their high-paid advisors. The currently popular manipulative takeover tactics have been developed by players of the takeover game with a huge financial stake in continuing the takeover frenzy. There is simply too much money to be made by raiders and their lawyers and investment bankers for this not to be the case. Boards of directors must continue to be able to respond in a flexible manner, subject to the limitations of their fiduciary duties and other applicable requirements of state law.

Third, the advantage enjoyed by corporate raiders results in part from market forces -- such as the large percentage of corporate stock held by institutional investors and the enormous power of arbitrageurs -- which are not likely to be affected by any Williams Act reform legislation. Corporate defenses will still be necessary to help even the scales.

* * *

Your second question is: "What has been the effect of hostile takeovers on employees of target companies?" (I can advise that, in the case of Goodyear, the effect has been devastating.

Goodyear survived a hostile takeover attempt by Sir James Goldsmith only by shrinking the company some 12% As a result, three plants are being closed and some 4,000 jobs will be eliminated. Substantially greater debt has been incurred, and research and development spending has been reduced and refocused to the shorter term.

All of our employees -- both those who have lost or will lose their jobs and those who will not -- have gone through months of uncertainty as to their future. As I have noted, some 4,000 employees will lose their jobs. Those who remain with Goodyear will work in a more narrowly focused company, without all of the growth potential and possibilities for advancement that would otherwise have existed.

Goodyear's experience is not aberrational. Rather, it is a widely observed fact that employees do not fare well when takeovers occur.)

Peter Drucker, the respected business professor and commentator, observes that "employees, from senior middle managers down to the rank and file in the office or factory floor, are increasingly being demoralized -- a thoughtful union leader of (his) acquaintance calls it 'traumatized' -- by the fear of a takeover raid." [1] As others have noted, when a takeover bid is made, "(m)any key employees -- well aware of acquisitors' penchant these days for wholesale layoffs and salary and benefit cuts -- quit rather than wait out an uncertain future, or are so distracted from their work that the company suffers." [2]

Employee fears of takeover-induced restructurings and resulting losses of jobs or benefits are, if anything, increasing. For example, Holiday Corp., the parent company of the Holiday Inns hotel chain, recently announced a massive operational and financial restructuring, apparently motivated in large part by fear that Holiday was a likely takeover target. Because of employee concerns about the restructuring, which they saw as "extraordinarily risky", a union representing Holiday employees in Las Vegas asked the Nevada Gaming Control Board to require that Holiday post a $80 to $100 million bond to protect the wages and benefits of Holiday's approximately 6,000 Nevada workers. To allay similar fears, and to protect themselves from abusive takeovers, many companies are adopting or considering so-called "tin parachutes", which provide substantial protections for employees at all levels in the event of a hostile takeover.[3]

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[1] Drucker, "Taming the Corporate Takeover", Wall Street Journal Oct. 30, 1984, p. 30

[2] "Here Comes the "Tin Parachute'", Dun's Business Month Jan. 1987, p. 62

The employees' fear of hostile takeovers is not at all surprising when one considers the high probability that jobs or benefits will be lost in the aftermath of a raid. In testimony before the Subcommittee on Employment and Housing of the House Government Operations Subcommittee on March 31, 1987, Dr. Richard S. Belous, a labor economist with The Conference Board, estimated that as many as 600,000 managers have lost their jobs as a result of mergers, acquisitions and restructurings and said that his research has found a direct statistical correlation between the extent of acquisition activity and loss of jobs and reduced wages.

Overall, according to The Wall Street Journal estimates, between January 1984 and mid-July of 1985 alone, at least 98 operational restructurings of companies resulted from or followed acquisitions, which affected approximately 550,000 employees.[4] Some of the more significant acquisitions in recent years have resulted in substantial job losses. For example, when Sperry Corp. succumbed to a hostile bid by Burroughs Corp., some 9,600 jobs reportedly were to be eliminated. When Safeway was subjected to a hostile bid by the Haft family and was then acquired by an investor group in a leveraged buyout, an estimated 3,500 jobs were lost. After a hostile bid was made for Midcon Corp., it was acquired by Occidental Petroleum and 2,000 jobs were phased out, with another 1,000 expected to follow. After Baxter Travenol Laboratories Inc.'s acquisition of American Hospital Supply Corp., 6,500 jobs were expected to be eliminated over a four-year period. Finally, when Socal acquired Gulf Oil, after Gulf had been put into play by a hostile partial tender offer by a group headed by T. Boone Pickens, Socal promptly offered early retirement to 12,000 employees, laid off or transferred 5,830 employees and the jobs of 15,000 service station operators were threatened. By June 1986, Chevron Corp., the company resulting from the merger, had cut its combined workforce from about 79,000 immediately following the merger to 52,000 employees.

Even if the company remains independent, employees still fear a bid and its aftermath because they know that their company is likely to be so weakened that jobs again will be threatened. For example, Carl Icahn's unsuccessful raid on Dan River, a textile manufacturer in Danville, Virginia, left the firm burdened with debt. Moreover, Dan River had to eliminate 2,000 local jobs -- while Icahn earned an estimated $8.5 million profit on his $14 million investment. Similarly, after Boone Pickens' and Icahn's successive raids on Phillips Petroleum, Phillips' work force declined from 29,300 to 22,000 employees, a third of which, a Phillips' executive claimed, were directly attributable to Icahn's raid.[5]

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[3] Cowan, "New Ploy: 'Tin Parachutes'", New York Times March 19, 1987, p. D1

[4] "Shifting Strategies", Wall Street Journal Aug. 12, 1985, p. 1

Job losses cost society vast sums in unemployment, welfare and retraining programs, not to mention the enormous damage to the morale and spirit of the American worker. But over the long haul, as William C. Norris, founder and then Chief Executive Officer of Control Data Corp., has pointed out, takeovers not only eliminate current jobs but also inhibit the creation of future jobs:

> If public concern for the social trauma of takeovers doesn't bring constraints, the increasing economic damage from unemployment certainly should. The most serious economic damage results from the destruction of job-creating resources. Technological innovation is the well-spring of new jobs. Immediately after a takover, an innovation-stifling process sets in. The aggressor blankets the other with bureaucracy, layer upon layer. Proposals for new products languish. The result is the dispersal of the entrepreneurial team, the major job-creating resource.[6]

Arthur Burck, a specialist in corporate mergers, acquisitions and reorganizations, likewise writes:

> If there are wholesale firings or, as usually happens following a hostile takeover, many executives leave, the acquired business often loses momentum. The people who leave are usually key employees, and many of those who remain vegetate rather than make waves. Employee morale and efficiency decline. Productivity suffers, creativity fades. In time the damaged company is quietly "phased out" or, if it is salvageable, sold off.[7]

Leigh Trevor, an attorney with Jones, Day, Reavis & Pogue, has pointed out another way in which takeovers may adversely affect target employees. According to Trevor, in several cases "the acquiring company has utilized funds of the target company's pension plans to assist in the acquisition." the raiders must protect benefits already earned when they draw out these funds, the plans are nevertheless weakened in that the excess funds are no longer available to provide or protect benefits to be earned in the future.

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[5] "Carl Icahn: Raider or Manager?", Business Week Oct. 27, 1986, p. 98, 104

[6] Burck, "The Hidden Trauma of Merger Mania", Business Week Dec. 6, 1982, p. 14

[7] Id.

Trevor identifies the following: Mobil, which obtained $29 million from the Superior Oil fund; Pantry Pride, $88 million from Revlon's; Irwin Jacobs, $97 million from AMF's pension fund, nearly 20 percent of the total purchase price; Texaco, $250 million from the Getty fund; Occidental, $400 million from the Cities Service pension fund. Given the phenomenon of "greater leveraging up and paying off debt at the expense of pension funds of the target companies," he asks, "what is the long-range impact on the morale and productivity of the American work force, white collar as well as blue collar?" [8]

In the words of Wayne E. Glenn, President of the United Paperworkers International Union:

> No matter which side wins control in a takeover battle, workers, customers, and the community in which the company is located are the likely ultimate losers. The company normally winds up saddled with added debt or otherwise weakened. Workers too often involuntarily finance the costs of the raid by job losses or pay cuts. If the costs cannot be passed off to others, productive assets are liquidated -- again to the detriment of workers and their communities. [9]

Is it any wonder that employees fear hostile takeovers so much?

Sincerely,

Robert E. Mercer RAV

Robert E. Mercer
Chairman of the Board

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[8] Trevor, "Hostile Takeovers -- the Killing Field of Corporate America", Address to the Financial Executives Institute March 11, 1986, p. 15-16

[9] Statement of AFL-CIO, Hearing on Impact on Workers of Takeovers, Leveraged Buyouts, and Greenmail before the Subcommittee on Employment and Housing of the House Committee on Government Operations 1
March 31, 1987

The Goodyear Tire & Rubber Company

SUITE 800 - 1800 K STREET, NORTHWEST
WASHINGTON, DC 20006

PHONE (202) 872-8500

May 27, 1987

The Honorable William Proxmire
Chairman
Senate Banking Committee
Room 534
Dirksen Senate Office Building
U.S. Senate
Washington, DC 20510

Attention: Mr. Steve Harris

Dear Mr. Chairman:

Attached are the responses of The Goodyear Tire & Rubber Company to some additional questions you posed on the subject of corporate takeover reform. We hope that they will serve as a useful addition to the record on this important issue.

The views expressed in these answers do not necessarily reflect the direct and personal experience of Goodyear. We thought it would be more valuable for policy-setting purposes to take a broader view than that of our own company in our answers.

If you or your staff has any questions, please do not hesitate to call me at 872-8500.

Sincerely,

Isabel E. Hyde
Washington Representative

Attachment

I. MANIPULATIVE TAKEOVER ATTEMPTS

In your first question, you ask: "What evidence do you have to support the view that hostile tender offers are started because corporate bidders hold a large block of target stock which they want to sell at a profit, rather than from a desire to actually buy and operate the company?"

Although takeover bidders may say a lot of different things about their intentions, actions speak louder than words. The track record of Carl Icahn, Ronald Perelman, Irwin Jacobs, the Belzbergs, Asher Edelman, Sir James Goldsmith, the Hafts and virtually all of the other well-known takeover artists stands as stark evidence that, under existing rules, these people can make enormous profits with relatively little effort -- often simply by acquiring a block of stock of a target and putting the company "into play." Only in extremely rare cases do they actually take over their targets. Much more frequently, the accumulation of a block of the target's stock and the initiation of takeover activity results in a run-up in the price of the target. This permits the takeover bidder to sell his block at a profit to the target in a greenmail transaction, to the target as part of a corporate restructuring undertaken in response to his accumulation, or to a third party.

There is an increasing amount of direct evidence to suggest that most takeover bidders are looking for the quick profit and have no intention of actually taking over their targets. For example, in 1985 the American Lawyer obtained a confidential 1980 memorandum from Carl Icahn to prospective investors setting forth, in a startling blunt fashion, his takeover plans. According to that memorandum:

> "It is our opinion that the elements in today's economic environment have combined in a unique way to create large profit-making opportunities with relatively little risk... It is our contention that sizable profits can be earned by taking large positions in 'under valued' stocks and then attempting to control the destinies of the companies in question by:
>
> a) trying to convince management to liquidate or sell the company to a 'white knight';
>
> b) waging a proxy contest or;
>
> c) making a tender offer; and/or
>
> d) selling back our position to the company."

True to his word to his investors, Icahn has made millions putting targets into play; according to press reports, he has taken option (d) or some variation thereof at least nine times. The following are profits (as reported by the press) from just some of his transactions:

- $3,000,000 for buying a 6% stake in Anchor Hocking and selling it back to the company in a greenmail transaction (doubling his money) one month later.
- $7,000,000 from American Can in greenmail when American Can bought 1,000,000 shares back from him at a 30% above-market premium.
- $9,000,000 for taking a position in Dan River and threatening a takeover, which led to a leveraged buyout initiated in response to his threats.

- $13,000,000 for acquiring a 10% stake in Uniroyal and selling it back to the company in a greenmail transaction, before Uniroyal went private in a leveraged buyout.
- $10,000,000 from Goodrich after acquiring just under 5% of that company and reselling it in a greenmail transaction at 25% above the then-market price.
- $35,000,000 for purchasing over 5% of Phillips Petroleum, threatening management with a two-tier tender offer and then disposing of his block after the sweetening by Phillips of a previously announced recapitalization plan.

Other takeover bidders have also had their motives questioned. The attached article from The Wall Street Journal discusses the track record of Jacobs, Edelman and the Belzberg family, all of whom have profited from selling out their stakes in takeover targets. For example, according to press reports:

- Edelman made approximately $30,000,000 after acquiring just under 10% of Fruehauf Corp. and announcing a two-tier tender offer when another group took that company private in a defensive leveraged buyout. As frequently happens, Fruehauf also paid Edelman $21,000,000 in part for his investment bankers' and legal fees.

- Jacobs, who always disclaims any intention of seeking greenmail, nevertheless profits by selling out after threatening takeover fights. In one case, he and his associates made a profit of over $28,000,000 after buying 7.7% of Walt Disney, threatening a proxy fight for control and then selling his block to the Bass family. In another, he and his associates made $31,900,000 after acquiring over 11% of Avco, threatening a takeover and then selling his block to Textron and in the open market.

Other takeover bidders have similar records of "success." For example:

- The Haft family, through the Dart Group, has profited handsomely from "unsuccessful" takeover attempts for Beatrice Foods, May Department Stores and Jack Eckerd Drugs. In one case they made approximately $140,000,000 after attempting a takeover of Safeway when they sold their block to Kohlberg Kravis Roberts in a leveraged buyout.
- Perelman earned over $40,000,000 after acquiring more than 8% of CPC Corporation and apparently selling his block to CPC through CPC's investment banker, Salomon Brothers. And he made about $34,000,000 in greenmail after acquiring approximately 14% of Gilette Company and then selling it back to Gilette.

- Goldsmith made $50,500,000 for acquiring 8.6% of St. Regis Corp. and then reselling it in a greenmail transaction back to that company.

The track record of T. Boone Pickens, one of the most successful and well-known takeover bidders -- and one of the most articulate spokesman for keeping the takeover frenzy going -- is virtually identical. Pickens, like the others, almost never completes an acquisition after acquiring a block of a target's stock and initiating takeover activity. In fact, in his recent book, Boone, he documents only two successful acquisitions by Mesa, his company. One, which occurred several years ago, was a negotiated deal which began as an unfriendly exchange offer. In the second one, his company acted as a white knight.

Boone also reveals that Pickens never intended, or even wanted, to gain control of many of his targets. For example, he admits that, "[w]ith Superior Oil, we were just an investor looking for a place to make a buck"; and "[w]ith Gulf [Oil], the prospect of acquiring the giant was unthinkable; we were just trying to get the management to do something for the shareholders, namely, get the price up." In the General American Oil (GAO) takeover, he admits that Mesa Petroleum Company's offer was a "no-brainer" because there was a "consolation prize" in the event that Mesa got outbid. Mesa owned 8% of GAO and had issued bonds that gave the holders the right to convert them into Mesa's block of GAO stock. However, unless the GAO stock price increased, Mesa would have to pay off the bonds. Thus, "[t]he only way to avoid a sure loss was to make an offer for GAO." In other words, Mesa's intent in making an offer was to push the GAO stock price up to avoid having to repay the bonds, not to take over the company. As one Delaware court put it, "Mesa has made tremendous profits from its takeover activities although in the past few years it has not been successful in acquiring any of the target companies on an unfriendly basis." The Delaware Supreme Court has noted Mesa's past history of greenmail, calling Mesa a "corporate raider with a national reputation as a 'greenmailer.'"

Pickens' record is replete with examples of takeover attempts in which Pickens never acquired his target, but rather sold out for a short-term profit -- often at the expense of the remaining shareholders. The following are estimated profits from some of his transactions:

- $32,000,000 for announcing a hostile tender offer for Cities Service and selling back his block to that company.
- $45,000,000 when Phillips Petroleum completed a white knight merger with General American Oil.
- Almost $32,000,000 for selling back Mesa's stake in Superior Oil, ending months of takeover rumors.
- Pickens and his partners made $760,000,000 with Mesa's share over $500,000,000 by establishing a beachhead in Gulf Oil stock, announcing a partial tender offer and

then watching Standard Oil of California complete a white knight merger with Gulf to form Chevron.

- $89,000,000 after Phillips underwent a major, debt-laden restructuring and bought back Mesa's accumulated Phillips stock.
- In Pickens' Unocal fight, despite rumors that he lost money, Pickens ended up making $83,000,000 (after taxes) by selling shares back to Unocal after withdrawing Mesa's hostile tender offer.

As the number of "unsuccessful" takeover raids continues to mount, the public is beginning to recognize what is really going on: takeover bidders believe that the profits lie in the takeover process, not in actually acquiring control of a target and trying to run it. According to a recent Harris poll commissioned by the Institute for the Study of Private Enterprise at the University of North Carolina, four out of five persons polled agreed that most hostile takeovers "engineered by groups of big investors who are trying to drive up the price of the stock just to make a profit for themselves," and, by 72% to 19%, those polled agreed that hostile bidders "often are not interested in taking control over a company but instead are interested in greenmail, being paid a big profit from the management, as a price for their dropping their takeover bid."

Under existing rules, it is certain that tender offers and other takeover bids will continue to be made by persons whose primary motive is to share in the obscene profits than can be made. The record shows that there is simply too much easy money to be made for this not to be the case.

* * *

II. DISCLOSURE OF STOCK ACCUMULATIONS

You also ask the following: "A number of people have recommended that there should be increased disclosures regarding stock accumulations. What additional disclosures would you recommend and why?"

Secret stock accumulations are a key element of most takeover bidders' strategies. By acquiring a significant block of a target's stock without disclosing his activities, a bidder can virtually assure himself of profit when the stock price increases after the accumulation is announced. Unfortunately, the profit made by the bidder comes at the expense of unwitting shareholders who sold to him during the secret accumulation program.

When a takeover bidder establishes his "beachhead" in the target before reporting to the SEC, he deprives selling shareholders of the crucial information that he is planning a takeover bid, which would put the target "in play" and likely result in a run-up of its stock price. The record is full of examples of how far bidders will go to keep their buying programs secret. One such case is Mesa's secret acquisition program for shares of Gulf, which Boone Pickens described as follows:

> "It was important to keep our buying a secret, in part to maintain the advantage that comes with surprise, in part to avoid a run-up in the price... We devised an elaborate security system. Only a handful of people at Mesa were privy to our buying, and only two knew the details of the transactions. We drew down our entire line of credit in advance, so that our banks would not detect a pattern of borrowing and buying. We established numbered bank accounts with restricted transfer procedures. Only one person at each bank knew that the accounts belonged to Mesa, and only Sydney Tassin knew all the account numbers and transfer authorizations. When it was time to pay, we would transfer cash from a Mesa account to one of the numbered accounts, then transfer it again to another numbered account at a different bank. The money was then transferred to Bear, Sterns & Company to pay for the stock."

The obvious effect of this secrecy is that, during the buying program, the target's shareholders do not seek or obtain a control premium in their selling price. When the bidder's holdings and intentions finally are announced, and the stock price climbs, shareholders who already sold to the bidder are left out.

To correct this unfairness, I would recommend: disclosur on a more timely basis; lowering the threshold that triggers the reporting obligation; adopting measures designed to deter false reporting and evasion of reporting by groups; and requiring more complete reporting by certain persons and entities, including institutional investors, who evade, or who are not currently subject to, full disclosure obligations. Each of these recommendations is discussed in turn.

1. The delay in reporting holdings should be reduced. Under existing law, a takeover bidder may delay reporting his accumulation under Section 13(d) of the Securities Exchange Act until 10 days after his holdings pass 5%. This 10-day

period, referred to as the "10-day window," provides ample opportunity for substantial profit by the bidder at the expense of the selling shareholders who, as discussed above, sell to the bidder without knowledge of the acquisition program and who as a result do not obtain a control premium. The 1983 Report of the SEC's Advisory Committee on Tender Offers stated: "The 10-day window... present[s] a substantial opportunity for abuse, as the acquirer 'dashes' to buy as many shares as possible between the time it crosses the 5% threshold and the required filing date."

Some recent examples of abuse of the 10-day window include AFG Partners' offer for Lear Siegler in November 1986, in which it simultaneously announced that it had already acquired nearly 10% of Lear Siegler. No Section 13(d) filing had been made previously, even though AFG admitted that it had been buying stock since September. In early October of 1986 Lear Siegler's stock was trading in the mid-$50 range. By the time AFG announced its $85-a-share bid, the stock had risen to about $80 per share, fueled by rumors someone was acquiring a block. As a result, shareholders who sold in October gave up approximately $25 per share because of ignorance about AFG's intentions.

Sir James Goldsmith acquired an 11.5% block of Goodyear stock before announcing his holdings and intention to launch a tender offer bid. Goldsmith paid an average of $42.20 for each of those shares, proposed to offer $49 per share in his takeover bid, and eventually sold his stock back to Goodyear for $49.50 per share. His approximately $93,000,000 profit, like that made by AFG, came at the expense of innocent Goodyear shareholders who sold to him prior to the disclosure, and was made possible in significant part by the 10-day window. In his takeover of Crown Zellerbach, Goldsmith acquired an 8.6% block of Crown Zellerbach before reporting (though he had announced several months earlier he might acquire as much as 25% of the Company's stock). Goldsmith paid $32 to $35 per share before reporting his holdings. After his report was filed, the stock price rose steadily into the low-$40 range.

Carl Icahn likewise acquired a 9.8% block of USX and 20.5% of TWA before reporting. In his USX bid Icahn paid an average of only $21.50 per share for his beachhead stake, but his initial tender offer was $31 per share. Millions were lost by shareholders who sold before the Section 13(d) filing.

2. The amount of stock that triggers the reporting obligation should be lowered. Even if the delay in reporting is shortened, bidders would nevertheless continue to reap profits at the expense of unwitting shareholders. By permitting acquisitions of up to 5% without any reporting, AFG, Icahn and Goldsmith still would have profited from the Lear Siegler, Goodyear, Crown Zellerbach, TWA and USX shareholders who sold before a Schedule 13D was filed. The amount of stock necessary to trigger a filing obligation thus should be reduced to an amount lower than 5% so as to deter raiders from profiting by their secrecy at the expense of the shareholders.

3. False reporting of intentions should be more effectively discouraged. Takeover bidders often continue making purchases after reporting under Section 13(d) that they are purchasing merely "for investment." More often than not, such statements fail to disclose the bidders' real desire to seek control or put the company into play. As with failures to file, while such false statements are unlawful, they rarely result in any significant penalties.

For example, when Pickens originally filed a Schedule 13D to report his Unocal holdings, he claimed they were "solely for investment." When Pickens launched a takeover bid for Unocal, Unocal sued to enjoin the offer alleging that Pickens' initial filings falsely represented his intentions. A California federal court agreed, concluding that Pickens' Mesa Partners II "from the outset intended to put Unocal 'in play' and thereby either obtain control or 'greenmail' the corporation in exchange for dropping its bid." As is frequently the case, however, the court's remedy was only to require corrective disclosures and a three-week extension of the tender offer withdrawal period. Equally disappointing was the SEC's remedy for its charges that Mesa had violated Section 13(d) by failing accurately to report its intentions for Gulf; Mesa was able to consent (without admitting guilt) to an injunction that restrained it from future violations.

4. Evasion of reporting requirements by groups should be eliminated. Takeover bidders also act collectively to evade the

reporting requirements until they have accumulated enough stock. If each person's holdings in a target remain below 5%, by not admitting that they are acting together as a "group," takeover bidders and arbitrageurs can significantly increase the amount of stock they control and continue to buy in secret from unsuspecting shareholders without reporting under Section 13(d). Unfortunately, without disclosure of agreements and contacts between members of such a group, it is extremely difficult to detect and prove that the group is operating when it engages in secret collusion.

Allegations of collusion among bidders, arbitrageurs, investment bankers, institutional investors and other market professionals are now coming to light in significant numbers. For example, as the attached articles suggest, there have been charges that Carl Icahn and Ivan Boesky jointly attempted to put Gulf & Western Industries into play in 1985. Although their aggregate holdings exceeded the 5% threshold, they were not reported to the SEC or the issuer. Eventually Gulf & Western reportedly was forced to buy back their stock in order to end takeover rumors. The attached articles also report that Icahn and Boesky worked together throughout Icahn's bid for Phillips Petroleum in 1985.

Furthermore, in two cases this year, the Government has brought charges alleging illegal arrangements to "park" stock with one another to conceal the stock's true ownership. In late January, Michael Davidoff, Boesky's chief trader, pleaded guilty to criminal charges that he had parked stock through bogus trades with Seligmann, Harris & Company, a London broker. The purpose of the trades, according to the charges, was to evade federal laws designed to protect investors by requiring brokers to maintain minimum amounts of capital. Additionally, according to the recent SEC complaint against Boyd Jefferies, Jefferies parked securities on behalf of Boesky's Seemala Corporation and Seemala parked securities at Jefferies, which, among other things, permitted Seemala to circumvent its Section 13(d) reporting obligations. Shares parked included securities in Pioneer and Phillips Petroleum, both of which were takeover targets.

5. Reporting requirements for institutional investors and similar entities should be expanded. It also appears that institutional investors, such as money managers, pension plans and similar persons and entities may be taking advantage of certain of the reporting requirements of the Securities Exchange Act to become involved in the takeover process without reporting their activities.

Under existing law, an institutional investor who holds more than 5% of a company's stock may be eligible to report on Schedule 13G (rather than Schedule 13D) if the investor is not holding the stock for the purpose of changing or influencing control of the company. The Schedule 13G need only be filed 45 days after the end of the calendar year in which the 5% threshold is crossed and be updated annually. The Schedule 13G essentially is a short-form Schedule 13D; in particular, no detailed information concerning the investor's purpose in holding the stock is required.

Yet there is now evidence that institutional investors have become involved in takeover activity. For example, it has been reported that Forstmann-Leff Associates, a pension fund manager, accumulated a block of stock of Hammermill Paper that at one time exceeded 16% of Hammermill's outstanding stock, which it reported on Schedule 13G. It is difficult to understand, however, how Forstmann-Leff could have properly reported the accumulation of such a significant block as a passive investor on Schedule 13G. Sure enough, having assembled its block, Forstmann-Leff then filed a Schedule 13D and, as the attached article reports, "metamorphosed from a passive investor into a militant one." Among other things, Forstmann-Leff contacted several potential takeover bidders for Hammermill and ultimately sold some of its stock to Paul Bilzerian, who immediately thereafter launched a takeover bid for Hammermill.

Moreover, under Section 13(f), institutional investors who manage $100,000,000 or more in certain securities need only report their holdings 45 days after the end of each calendar quarter (unless they trigger the Schedule 13G or Schedule 13D filing requirements). Thus, the activity by such investors in stocks of takeover targets, if reported at all, is reported long after it would be of use to investors. To make matters worse, institutional investors reporting under Section 13(f) may seek and obtain from the SEC confidential treatment of their filings. For example, Drexel Burnham Lambert has sought and obtained confidential treatment for six months for its filings under Section 13(f). Such treatment obviously makes it impossible for the investing public to learn of any takeover-related activities by active players of the takeover game (such as Drexel Burnham) until it is too late.

Therefore, as institutional investors become more involved in the takeover process, increased disclosure, and more timely disclosure, by such investors of their activities is essential to fairness and equal treatment of all shareholders.

The Wall Street Journal, March 20, 1987, pages 13, 35

Arbitragers Are Baffled by Bids That Often Fail To Materialize

HEARD ON THE STREET

By Randall Smith

Sometimes a takeover bid isn't really a bid.

A spate of conditional acquisition proposals in the past year has confounded Wall Street arbitragers, who have lost money betting on "bids" proposed—but never formally made—for such companies as USX Corp., Lucky Stores Inc. and Borg-Warner Corp.

Here is an example of what happens:

Last Nov. 25, Borg-Warner directors received a letter from Minneapolis investor Irwin Jacobs, who together with Minstar Inc. controlled 7.7% of the plastics, car parts and chemicals concern and proposed to buy the rest for $43 to $48 a share.

Although the figures he used were quite specific, Mr. Jacobs said he wanted to see the books before negotiating a friendly acquisition. Even though his letter didn't constitute a formal offer, it was referred to in news stories as a "bid" or an "offer," and the stock rose $1.375, to $39, in response.

But the gulf between the stock price and the figures cited by Mr. Jacobs reflected skepticism that such a bid would really arrive. The letter was viewed as a move to hasten a restructuring, or to spark a bid by another Borg holder, GAF Corp.

Since then the company largely has ignored Mr. Jacobs, who threatened a hostile tender offer Feb. 19, and the stock has lagged behind the market.

Such tactics are "in vogue," because they are "a cost efficient way of stirring up the stew," said Arthur Fleischer, a merger lawyer at Fried Frank Harris Shriver & Jacobson.

"What is a postage stamp, 22 cents?" he said. "You can cause a lot of consequences to a company by simply sending a letter. Basically, you may—but not necessarily—put the company in play," he said.

Lawrence Schloss, a mergers executive at Donaldson, Lufkin & Jenrette, said of those who make the proposals: "Some are your basic greenmail artists. Some are bona fide buyers who see value but really don't have the appropriate information to make an offer. And some are a combination of the two."

In an interview, Mr. Jacobs said he didn't write the letter merely to stir the stew or put Borg-Warner in play, and said the company has agreed to talk to him. "Don't assume nothing is happening. Don't assume we're just sitting here waiting for the phone to ring," he added.

But he acknowledged that disclosure of a proposal may put pressure on a company to deal with a suitor. "I think people who are running certain companies pay more attention to what Wall Street says sometimes. And if no one knows anything, then there's no pressure (for the company) to say anything."

In a typical pattern, an investor will buy a 5% stake, try to get arbitragers to buy shares, and then make a bid "proposal" to focus attention on the potential values. Mr. Schloss said that target companies must usually hire investment bankers to evaluate the proposal. "They have a fiduciary obligation to see if it's real and then respond."

Once in play, the target company may negotiate with the "bidder," seek a rescuing suitor, or execute a restructuring to boost the stock price. Plenty of takeover attempts turn into mergers or leveraged buyouts through just such a process.

"Maybe it's a way of starting talks with management. It works if you can find weak management that perceives itself as

Please Turn to Page 35, Column 3

[illegible] 'Bids' Fared

BIDDER TARGET COMPANY	'BID'¹ DATE²	STOCK'S INITIAL REACTION³	OUTCOME
TWA/Carl Icahn **USAir Group**	$52 3/4/87	+6⅜ to 49⅜	Bid, seen a ploy to get USAir to buy TWA, is shelved Monday with USAir at 45¾; closed Wed. at 44½
Columbia Ventures **Harnischfeger**	$19 2/23/87	+½ to 18¼	Harnischfeger rejects bid Feb. 26 with stock at 18⅝; closed Wed. at 17⅞
Irwin Jacobs **Borg-Warner**	$43-$48 11/25/86	+1⅜ to 39	Borg-Warner ignores Jacobs; stock lags market, closed Wed. at 41⅛
Carl Icahn **USX**	$31 10/6/86	+1⅛ to 27⅞	'Bid' expires Oct. 22 and stock later falls to 20; closed Wed. at 27¼
Asher Edelman **Lucky Stores**	$35 9/24/86	+1⅜ to 36	Lucky rejects bid and restructures; stock slumps to 26; standstill pact reached March 6; closed Wed. at 31⅛
Belzberg family **Ashland Oil**	$60 3/26/86	+2⅜ to 54⅜	Bid 'deadline' passes, Ashland buys back Belzberg stake at 51; stock slips below 47, rebounds to 63⅛ Wed.

¹Per share ²Announced or disclosed ³On first trading day bid was known

Arbitragers Are Often Baffled by 'Bids' That Don't Materialize Into Takeover Offers

Continued From Page 13

HEARD ON THE STREET

weak," said Julius Sas, a special situations analyst at the brokerage house Balis Zorn Gerard Inc. who has followed the Borg-Warner siege. "It's like pointing at them with an unloaded gun."

But for the corporate raider forced to pull the trigger in such a circumstance, the results can be an embarrassing "click." That's what happened at the denouement of Asher Edelman's pursuit of Lucky Stores, a California grocery chain.

Mr. Edelman's pursuit of Lucky had all the twists and turns of a Gothic novel. After accumulating a reported 3% stake, he proposed a $35-a-share friendly purchase in a letter disclosed Sept. 24. He demanded that any restructuring be "prompt and efficient. Lip service will not satisfy me."

After company officials refused to meet Mr. Edelman, Lucky stock peaked at $37.875 in early October on reports that the investor was ready to launch a hostile tender offer. But he didn't follow through on that threat after Lucky formally rejected the proposal Oct. 6 and began a defensive restructuring and stock buyback.

The investor then raised his proposed bid to $37 a share. Lucky rejected it again. Mr. Edelman dropped his proposal, then renewed it again Nov. 19 after buying more shares. But after holders approved the restructuring in late December, the stock fell to $26.

(Mr. Edelman was more determined in his pursuit of Ponderosa Inc. He disclosed a 19% stake in late November, and without further preliminaries, launched a tender offer Dec. 2 that, after some sweetening, snared the company.)

Two weeks ago, Mr. Edelman reached a three-year standstill agreement limiting his Lucky stake to 5% and barring him from attempting to gain control. Lucky paid him just $2.8 million to cover expenses.

Although Lucky shares have rebounded to $31.875, they have lagged behind the market since the takeover attempt, and some arbitragers are bitter. "As far as I'm concerned, he sold his credibility for $2.8 million," said one.

Mr. Edelman was out of the country this week and couldn't be reached for comment. His lawyer, Burton Lehman of Schulte Roth & Zabel, said that while Mr. Edelman's proposals "weren't bids in the nature of a tender offer, they were serious bids seeking to work out a basis to purchase the company. But the company rejected each of them and went ahead and did its restructuring."

Perhaps the most prominent "non-bid" bid was Carl Icahn's run on USX. Mr. Icahn and several other corporate raiders had taken positions in the depressed stock. On Oct. 6, he proposed a "friendly" $31-a-share acquisition, subject to a look at the books, but threatened a hostile tender if the company didn't accept or undertake a "radical" restructuring.

One prominent merger lawyer said arbitragers erroneously "treated Icahn's conditional approach to U.S. Steel as an unconditional bid. It wasn't a bid. He said he would make a bid 'if-if-if.' But the Street treated them as a company that was in play."

Mr. Icahn and USX management soon became embroiled in a lengthy effort to agree on conditions under which the investor could look at the books. Then the insider-trading scandals that broke in mid-November tainted his investment banker, Drexel Burnham Lambert, putting in doubt some raiders' ability to get financing and leaving Mr. Icahn stuck in USX. The stock fell to 20 before rebounding on higher oil prices. In January, he abandoned the effort, but still owns the stock.

This month, Mr. Icahn and his Trans World Airlines made a proposal for a bid that got set aside before it was ever made. TWA bought 15% of USAir Group stock and suggested it might bid $52 a share for the whole company after USAir made a bid to acquire Piedmont Aviation.

The Icahn move was widely interpreted as an effort to foil a combination that stood to rob him of two choice candidates to merge with—or, preferably, buy—TWA. But USAir rejected the bid as "highly conditional," among other things. After a federal judge blocked further purchases and Piedmont agreed to merge with USAir, Mr. Icahn said he wouldn't seek control for the moment.

Many bona fide tender offers are contingent on the target company dropping anti-takeover provisions, including a bid this week by AFG Industries and Wagner & Brown for GenCorp. Takeover experts said it is also legitimate for would-be acquirers to want to see a company's books.

A proposed bid in the oil patch that never actually materialized came from Canada's Belzberg family for Ashland Oil Inc. a year ago. The Belzbergs said they were prepared to pay $60 a share, but later accepted $51 a share from the company for their 9.2% stake.

Skeptics are already wondering about a proposal Feb. 23 from Columbia Ventures, a Miami-based partnership that said it might pay $19 a share for Harnischfeger Industries Inc. The stock, which initially ran up to $18.25 on the news, has since retreated to $17.625.

Of course, how a company treats a proposal varies according to the proposer's identity. Mr. Schloss of Donaldson, Lufkin & Jenrette said if it's, say, Texaco Inc., directors have to consider it seriously. But, as Borg-Warner observed last month: "We do not consider letters from Mr. Jacobs as formal offers or legally binding."

In deciding how to value a target company's stock, arbitragers go through a similar thought process. Even though they have all taken greenmail in the past, Messrs. Icahn and Jacobs and Canada's Belzbergs have gained credibility by actually buying companies on occasion.

However, one takeover speculator focuses on the target company instead of on the proposer. "It doesn't matter whether the bidder is serious," says this arbitrager. "You look to see whether the target is going to care. Just look at the board of directors. People who are from the Boy Scouts of America" aren't likely to put up as much resistance as "someone whose name is on the company."

The Washington Post, November 18, 1986, pages E1, E2

Takeovers Fueled by Ties Of Raiders to Speculators

1985 Bid for Phillips Petroleum Illustrates the Bond

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Trader Ivan F. Boesky, above, called raider Carl Icahn, below, frequently before Icahn's hostile takeover bid for Phillips Petroleum, depositions sho

By David A. Vise and Peter Behr
Washington Post Staff Writers

The multibillion-dollar takeover boom of the mid-1980s has been fueled in part by a close, controversial relationship between corporate raiders and professional traders like Ivan F. Boesky, who speculate on takeover bids.

That relationship is under intense scrutiny now, following the fall of Boesky, Wall Street's leading speculator, who has forfeited $100 million in penalties and profits from illegal insider trading.

One close look at the interconnection between raiders and speculators is provided by the takeover campaign against Phillips Petroleum Co. in 1985, which involved Boesky and corporate raider Carl Icahn.

The Phillips drama highlights the potential for large-scale speculators like Boesky to add momentum to takeover campaigns.

A Securities and Exchange Commission investigation into the Phillips case has produced no charges against any of the participants.

Depositions in private lawsuits show that Icahn had frequent telephone conversations and several meetings with Boesky just before Icahn launched a hostile takeover bid for Phillips early in 1985.

About the time that Icahn revealed his bid for Phillips—which sharply increased Phillips' stock price—Boesky bought between 4 million and 5 million shares of Phillips stock.

What the public record does not reveal is when Boesky bought the Phillips stock, whether he took advantage of advance knowledge of Icahn's plans, and to what extent his involvement helped Icahn pursue his takeover attempt for the Bartlesville, Okla., oil company.

The record shows that Boesky, who spent 20-hour days pumping Wall Street sources for information, subjected Icahn to the same nonstop attention during the Phillips campaign.

"He calls me every day," Icahn said in a Feburary 1985 deposition, when asked about his relationship with Boesky during the Phillips deal.

Phillips officials, who were furious about

See RAIDERS, E2, Col. 4

Traders' Ties to Raiders Spotlighted

RAIDERS, From E1

Boesky's role in the takeover raid against them, had no comment yesterday about the SEC's complaint against Boesky. "We are watching with interest," a spokesman said.

The battle for control of Phillips began with a takeover bid from another raider, T. Boone Pickens Jr., chairman of Mesa Petroleum Co., in December of 1984. Pickens' hostile bid was opposed by Phillips' management and board of directors.

By Dec. 4, 1984, Pickens owned 5.8 percent of Phillips stock, and he announced his intention to acquire the company. Pickens said he would not drop his bid or sell his shares back to Phillips unless all shareholders were included in any deal.

Despite his earlier assertions, however, Pickens did end his takeover bid late in the evening on Dec. 23 in return for $53 a share in cash from Phillips, a deal not offered to other shareholders.

Pickens, like Icahn and so many other prominent deal makers, talked frequently with Boesky. "Ivan is my friend," Pickens said shortly after the SEC's action against Boesky was announced on Friday. "Ivan is still my friend."

Yesterday, Pickens and Mesa President David Batchelder said they never received a request from Boesky for confidential, inside information about their takeover plans. "I can tell you in my discussions with Ivan, Ivan never asked for or received any inside information," Batchelder said.

When Pickens dropped his bid for Phillips, Boesky was notified almost immediately by his aides, who reached him in Barbados. As Boesky tells the story, he was stunned by the news that Pickens had agreed to drop his takeover bid.

Boesky had purchased millions of Phillips shares in the hope that Pickens either would acquire the company or force it to take steps that would raise the price of its stock.

Fearing that Pickens' action would cause a sharp drop in Phillips' stock price when the market opened on Christmas Eve morning, Boesky cut short his family vacation and flew back to New York, but it was too late to unload the stock before the price dropped.

His fears were on target. Phillips stock dropped almost 10 points on Dec. 24, imposing huge potential losses on Boesky and other arbitrageurs—the professional speculators who gamble on the outcome of mergers and takeover bids. Boesky owned 5.87 million Phillips shares on Dec. 31, which still were worth more than $200 million.

With Phillips stock trading at a depressed price in the low 40s after Pickens' pullout, Icahn began aggressively buying shares. According to the deposition given by Icahn, Icahn intially was not sure whether he would make a takeover bid for Phillips. Shortly after his initial purchase of Phillips stock, Icahn said, he received a telephone call from Boesky.

"I hear you are involved with Phillips," Boesky said, according to Icahn's deposition.

Boesky said he was upset about the settlement Phillips had reached with Pickens, according to Icahn.

"He [Boesky] was really angry as to what they did," Icahn said.

Icahn testified that Boesky suggested they should join forces against the Phillips board in a proxy fight. In a proxy fight, the pair would have attempted to gain control of Phillips by having their own slate of directors elected to the company's board.

Icahn said in the deposition that he told Boesky he was not interested in joining him in a proxy fight, but Boesky continued to call Icahn.

Sometime in early January, Boesky and Icahn met at Boesky's Westchester County, N.Y., estate to disuss "different strategies" they could use to increase the price of Phillips stock. Among the strategies, Icahn said, was a possible joint takeover bid for Phillips. Icahn said he told Boesky that Boesky would have to put in $100 million to $150 million of cash to join Icahn in a takeover bid.

The meeting ended without any agreement between the two men, but throughout January, according to Icahn, Boesky continued to call Icahn and ask what he was going to do with his Phillips stock. Meanwhile, Icahn continued to buy Phillips stock at an increasingly rapid pace.

Late in January, Icahn decided he was going to make a takeover bid for Phillips. On Jan. 28, Icahn bought 2.74 million shares of Phillips from Boesky in a private deal totaling about $47 a share.

On Monday evening Feb. 4, Icahn delivered a $55-a-share takeover bid to Phillips, which was publicly announced.

Five days later, on Feb. 9, Boesky went to dinner at the Icahn residence, according to Icahn's deposition. Over dinner, they discussed the possibility of Boesky joining Icahn in his takeover bid. Meanwhile, Icahn testified in his deposition that Boesky had purchased "quite a bit of stock again . . . 4 to 5 million shares."

Icahn said he is not sure whether he learned of Boesky's stock purchase on Feb. 9 or a few days earlier. Icahn and Boesky met again on Feb. 10 to continue their discussion about a possible joint bid, according to Icahn. Once again, they did not reach any agreement.

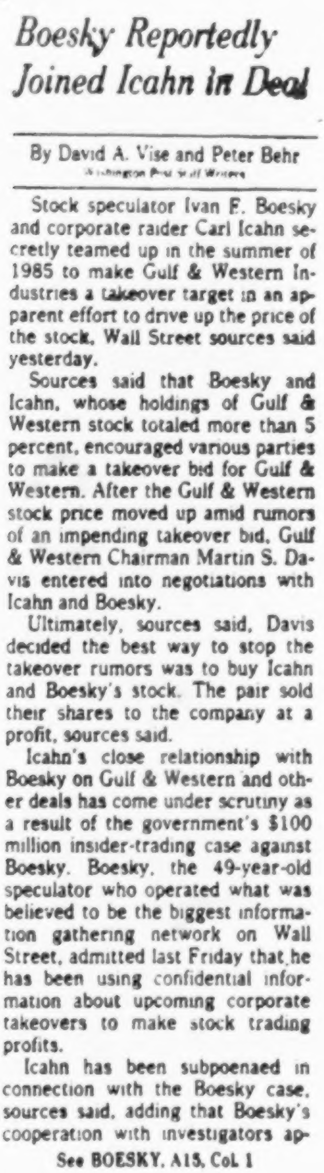
During the next month, Icahn and Phillips reached an agreement in which Icahn dropped his hostile takeover bid, Phillips paid him $25 million in cash to cover his expenses and Phillips offered all shareholders a package of securities with a face value of $62 a share. By March 31, Boesky had sold all of his Phillips shares.

Securities rules require that any person who possesses material nonpublic information about a takeover offer or proposed takeover offer disclose the information publicly or refrain from trading. This requirement applies if a person knows or has reason to know, that the information has been obtained directly or indirectly from the bidder, the target company or others with confidential inside information.

The SEC's complaint against Boesky charged that former Drexel Burnham Lambert investment banker Dennis B. Levine provided Boesky with confidential takeover information in return a percentage of Boesky's trading profits.

But there is a widespread belief on Wall Street that others, including investment bankers and corporate raiders, have leaked information to Boesky for different goals, including the hope that their takeover bids would succeed if Boesky, a powerful market force, bought stock in their takeover target.

The Washington Post, November 19, 1986, pages A1, A15



Boesky Reportedly Joined Icahn in Deal

By David A. Vise and Peter Behr
Washington Post Staff Writers

Stock speculator Ivan F. Boesky and corporate raider Carl Icahn secretly teamed up in the summer of 1985 to make Gulf & Western Industries a takeover target in an apparent effort to drive up the price of the stock, Wall Street sources said yesterday.

Sources said that Boesky and Icahn, whose holdings of Gulf & Western stock totaled more than 5 percent, encouraged various parties to make a takeover bid for Gulf & Western. After the Gulf & Western stock price moved up amid rumors of an impending takeover bid, Gulf & Western Chairman Martin S. Davis entered into negotiations with Icahn and Boesky.

Ultimately, sources said, Davis decided the best way to stop the takeover rumors was to buy Icahn and Boesky's stock. The pair sold their shares to the company at a profit, sources said.

Icahn's close relationship with Boesky on Gulf & Western and other deals has come under scrutiny as a result of the government's $100 million insider-trading case against Boesky. Boesky, the 49-year-old speculator who operated what was believed to be the biggest information gathering network on Wall Street, admitted last Friday that he has been using confidential information about upcoming corporate takeovers to make stock trading profits.

Icahn has been subpoenaed in connection with the Boesky case, sources said, adding that Boesky's cooperation with investigators ap-

See BOESKY, A15, Col. 1

Boesky, Icahn Reportedly Teamed Up on Stock Plan

BOESKY, From A1

parently led to scrutiny of Icahn. A subpoena does not mean that someone is the target of an investigation, only that they have been asked to provide information.

Icahn, who recently seized control of Trans World Airlines after a tough, hostile takeover fight, and currently is in the midst of an $8 billion takeover bid for USX Corp., parent of U.S. Steel, disclosed in a 1985 deposition that he talked regularly with Boesky about his takeover bid for Phillips Petroleum Co.

"He calls me every day," Icahn said in a February 1985 deposition, when asked about his relationship with Boesky during the Phillips deal. Sources said an article describing their relationship, which appeared in The American Lawyer last year, triggered the initial SEC investigation of the Phillips deal.

"The one thing that is pretty clear over the years is Boesky and Icahn have traded information," one Wall Street source said. Icahn could not be reached for comment and Boesky's lawyers declined to reply to reporters' questions.

Meanwhile, Gulf & Western declined to discuss whether the company had purchased a block of stock from Icahn and Boesky to eliminate takeover speculation.

"We have had a stock repurchase program in effect for the past three years," the company said. "During those three years, we have bought back over 18 million shares. We have purchased those shares from just about every major broker. We usually don't know who the sellers are and, in any case, we would not identify them."

Securities and Exchange Commission rules require investor groups that own more than 5 percent of a public company to disclose their holdings. Icahn and Boesky made no such disclosure. Sources said that if their shares were added together, the total would be over the 5 percent threshold.

Prominent Wall Street firms have been told that Boesky secretly tape recorded conversations with his employes and outside business contacts in the last six weeks to provide federal investigators with evidence about illegal stock trading. During that period, sources said, Icahn and Boesky are believed to have discussed Icahn's takeover bid for USX Corp.

Sources said that Boesky's willingness to cooperate with the government's investigation was an important factor in what is widely regarded as his lenient settlement on criminal charges. Boesky has agreed to plead guilty to one criminal felony charge, which carries a maximum prison sentence of five years.

In contrast, former Drexel Burnham Lambert investment banker Dennis B. Levine, who the SEC says made $12.6 million trading stocks illegally on the basis of inside information, pleaded guilty to four criminal charges, which together carry a maximum sentence of 20 years. The SEC charged last Friday that Boesky agreed to give Levine a percentage of his stock trading profits in return for confidential information about upcoming corporate takeovers.

CARL ICAHN
. . . ties to Boesky under scrutiny

Sources said that Levine, a rising 33-year-old star in Drexel's merger department, tape recorded telephone calls with various Wall Street sources just before his arrest.

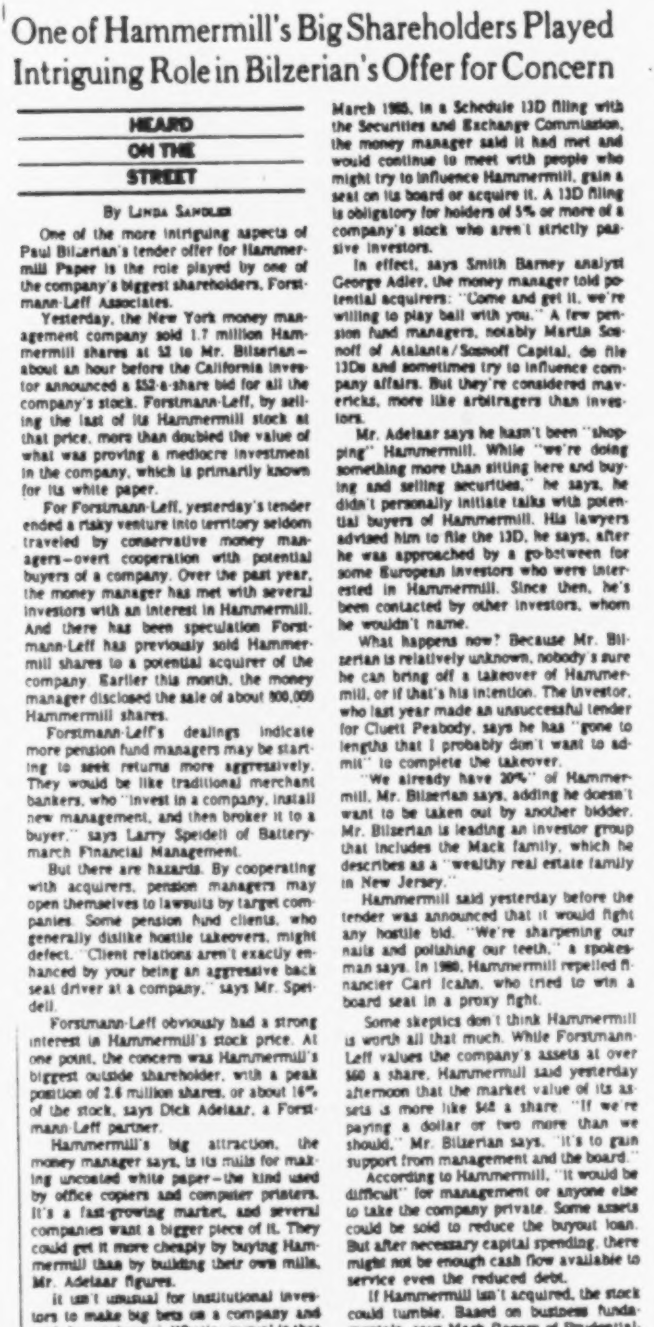
Drexel, the Wall Street firm that is financing Icahn's bid for USX, acknowledged on Monday that the firm received a subpoena in connection with the insider-trading investigation. Drexel has been asked to provide federal investigators with stock trading records and information about the firm's involvement in numerous takeovers and other deals. In addition, the government has asked Drexel for information about various Drexel employes.

In addition to the general Drexel subpoena, sources said Michael Milken, the man who runs Drexel's Beverly Hills, Calif., office, has been subpoenaed. Milken is credited with figuring out how to use risky, high-yielding securities known as "junk bonds" to finance multibillion-dollar corporate takeovers on behalf of Icahn and other individual raiders. Milken is considered to be the most powerful single individual playing the takeover game.

Rumors about Milken's relation to Boesky and rumors that he was about to resign were so heavy yesterday that Drexel issued a statement saying he had not resigned. Milken recently helped Boesky raise about $600 million to invest in stocks of takeover targets.

Lawyers familiar with the insider-trading investigation said the government is scrutinizing ties between Boesky and other senior Drexel investment bankers.

The Wall Street Journal, July 25, 1986, page 43



One of Hammermill's Big Shareholders Played Intriguing Role in Bilzerian's Offer for Concern

HEARD
ON THE
STREET

By Linda Sandler

One of the more intriguing aspects of Paul Bilzerian's tender offer for Hammermill Paper is the role played by one of the company's biggest shareholders, Forstmann-Leff Associates.

Yesterday, the New York money management company sold 1.7 million Hammermill shares at $52 to Mr. Bilzerian–about an hour before the California investor announced a $52-a-share bid for all the company's stock. Forstmann-Leff, by selling the last of its Hammermill stock at that price, more than doubled the value of what was proving a mediocre investment in the company, which is primarily known for its white paper.

For Forstmann-Leff, yesterday's tender ended a risky venture into territory seldom traveled by conservative money managers–overt cooperation with potential buyers of a company. Over the past year, the money manager has met with several investors with an interest in Hammermill. And there has been speculation Forstmann-Leff has previously sold Hammermill shares to a potential acquirer of the company. Earlier this month, the money manager disclosed the sale of about 900,000 Hammermill shares.

Forstmann-Leff's dealings indicate more pension fund managers may be starting to seek returns more aggressively. They would be like traditional merchant bankers, who "invest in a company, install new management, and then broker it to a buyer," says Larry Speidell of Batterymarch Financial Management.

But there are hazards. By cooperating with acquirers, pension managers may open themselves to lawsuits by target companies. Some pension fund clients, who generally dislike hostile takeovers, might defect. "Client relations aren't exactly enhanced by your being an aggressive back seat driver at a company," says Mr. Speidell.

Forstmann-Leff obviously had a strong interest in Hammermill's stock price. At one point, the concern was Hammermill's biggest outside shareholder, with a peak position of 2.6 million shares, or about 16% of the stock, says Dick Adelaar, a Forstmann-Leff partner.

Hammermill's big attraction, the money manager says, is its mills for making uncoated white paper–the kind used by office copiers and computer printers. It's a fast-growing market, and several companies want a bigger piece of it. They could get it more cheaply by buying Hammermill than by building their own mills, Mr. Adelaar figures.

It isn't unusual for institutional investors to make big bets on a company and wish for a takeover. What's unusual is that Forstmann-Leff metamorphosed from a passive investor into a militant one. In March 1985, in a Schedule 13D filing with the Securities and Exchange Commission, the money manager said it had met and would continue to meet with people who might try to influence Hammermill, gain a seat on its board or acquire it. A 13D filing is obligatory for holders of 5% or more of a company's stock who aren't strictly passive investors.

In effect, says Smith Barney analyst George Adler, the money manager told potential acquirers: "Come and get it, we're willing to play ball with you." A few pension fund managers, notably Martin Sosnoff of Atalanta/Sosnoff Capital, do file 13Ds and sometimes try to influence company affairs. But they're considered mavericks, more like arbitragers than investors.

Mr. Adelaar says he hasn't been "shopping" Hammermill. While "we're doing something more than sitting here and buying and selling securities," he says, he didn't personally initiate talks with potential buyers of Hammermill. His lawyers advised him to file the 13D, he says, after he was approached by a go-between for some European investors who were interested in Hammermill. Since then, he's been contacted by other investors, whom he wouldn't name.

What happens now? Because Mr. Bilzerian is relatively unknown, nobody's sure he can bring off a takeover of Hammermill, or if that's his intention. The investor, who last year made an unsuccessful tender for Cluett Peabody, says he has "gone to lengths that I probably don't want to admit" to complete the takeover.

"We already have 20%" of Hammermill, Mr. Bilzerian says, adding he doesn't want to be taken out by another bidder. Mr. Bilzerian is leading an investor group that includes the Mack family, which he describes as a "wealthy real estate family in New Jersey."

Hammermill said yesterday before the tender was announced that it would fight any hostile bid. "We're sharpening our nails and polishing our teeth," a spokesman says. In 1980, Hammermill repelled financier Carl Icahn, who tried to win a board seat in a proxy fight.

Some skeptics don't think Hammermill is worth all that much. While Forstmann-Leff values the company's assets at over $60 a share, Hammermill said yesterday afternoon that the market value of its assets is more like $42 a share. "If we're paying a dollar or two more than we should," Mr. Bilzerian says, "it's to gain support from management and the board."

According to Hammermill, "it would be difficult" for management or anyone else to take the company private. Some assets could be sold to reduce the buyout loan. But after necessary capital spending, there might not be enough cash flow available to service even the reduced debt.

If Hammermill isn't acquired, the stock could tumble. Based on business fundamentals, says Mark Rogers of Prudential-Bache Securities, Hammermill would trade "in the mid to high 30s."

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
WILLIAM D. SMITHBURG

Is there reason to believe that investment bankers, may be manipulatively putting companies into play for the fees involved without any regard for the future consequences of these transactions? If so, what evidence do you have to support this position?

Dear Senator Proxmire:

You asked if there is reason to believe that investment bankers may be manipulatively putting companies "into play" for fees involved without regard for the future consequences of these transactions.

To our knowledge, shares of The Quaker Oats Company have not been involved in such manipulative transactions. We closely monitor our stock but have not noticed anything unusual beyond the fact that Ivan Boesky had a large position in 1986. Meanwhile, various reports of financial analysts have alluded to Quaker as a potential takeover target from time to time.

Other reputed or actual takeover targets appear to have been subject to manipulative transactions by investment bankers that have lead, in some instances, to litigation. In addition, evidence revealed by recent insider trading investigations strongly indicates that information was traded among investment bankers in order to put companies into play, resulting in enormous profits for those involved. Beyond noting such public indication of manipulative practices, we believe it is appropriate to comment only on our own experience.

Sincerely,

Bill Smithburg

William D. Smithburg
Chairman and Chief
Executive Officer

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
ALVAH H. CHAPMAN, Jr.

NIGHT

H. Chapman, Jr
man and
Executive Officer
376 3870

Knight-Ridder, Inc
One Herald P
Miami, Florida 33132

March 31, 1987

The Honorable William Proxmire
Chairman
United States Senate
Committee on Banking, Housing and Urban Affairs
Washington, D.C. 20510-6075

Dear Senator Proxmire.

I am pleased to enclose my response to the question sent me with your letter of March 26th.

QUESTION FROM SENATOR WILLIAM PROXMIRE:

Some people say that the Wall Street insider trading scandal is a wholly separate problem from abuses in the conduct of hostile takeovers. Do you agree or disagree with that statement and, if you disagree please explain why you believe that the scandal is relevant to the Congress' consideration of amendments to the Williams Act.

ANSWER FROM ALVAH H. CHAPMAN, JR.

I agree that the insider trading scandal is a separate problem from abuses in the conduct of hostile takeovers. Illegal insider trading is a matter of great concern to the business community. But illegal insider information and the problems stemming from that are primarily a matter of enforcing existing laws.

The abuses of hostile takeovers are a separate problem worthy of congressional consideration for all the reasons which I cited in my earlier comments before your committee.

Sincerely,

Alvah H. Chapman, Jr.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM THOMAS R. DONAHUE

QUESTION 1. **On page 1 of your testimony you state that: "The engine fueling this activity (corporate restructurings) is the hostile takeover attempt." What percentage of takeovers and mergers are hostile? Do you feel that all financial restructurings are bad? How would you distinguish between a well-advised and an ill-advised corporate restructuring?**

REPLY:

I am sure you noted that in the paragraph preceding the sentence from my testimony which you quoted in question one, I referred to corporate restructuring as "including hostile takeovers, friendly acquisitions, leveraged buyouts, spin-offs, and recapitalizations." All of these forms of corporate restructurings are included as part of "this activity" being fueled by the hostile takeover attempt. It is not only those takeovers and mergers that are consummated that lead to adverse impacts upon employees and communities. In some of the actions which are initiated as hostile takeover attempts, the target company may be successful in fending off the raider by purchasing enough of its own stock in the market to retain control. In the process, however, the company may become so heavily indebted that it has to sell off valuable assets in order to repay some of the debt; and it is, thus, left in a much poorer position to withstand a downturn in the market for its products. An example of such a case was Phillips Petroleum's successful defense against a raid by Mesa Petroleum Company. The situation may become more aggravated when the raider is also paid off with greenmail; that happened in the 1986 defense of Goodyear Rubber Company against the raid by Goldsmith.

Probably the greatest number of restructurings stemming from hostile takeover attempts, hundreds annually, take place as leveraged buyouts. The management of a company that goes through a leveraged buyout often engages in that transformation after it has been threatened by raiders, or after a defense against a raider which involves buying back a lot of company stock at rising prices after the company had been put in play and also paid greenmail. This happened in the case of the recent Safeway Stores' defense against a takeover through stock purchases plus payment of greenmail, followed by a leveraged buyout.

The common ingredient in the above different types of restructuring is (1) that they all started with hostile takeover attempts and (2) the accumulation of massive debts, at times running into billions of dollars, which then gives rise to closedowns or sales of some assets and operations. Such actions are taken because of a large debt that has to be serviced; and in some cases, it places the entire company in a losing operating position, requiring immediate sell-offs to reduce the debt. In other cases, an increased net income standard has to be adopted by a company to service the debt, placing some operating units, that had met the previous income standard, in a submarginal category under the new income standard. Such operating units are then either sold or shut down.

Not all financial restructurings are bad. However, there is a much greater chance of obtaining bad effects from a restructuring that is undertaken under duress of defending against an unwanted takeover merger. Under those circumstances, the cost to the target company of the defense or the alternative of a leveraged buyout, which is also a form of defense, cannot be estimated in advance. The target company often ends up with a great deal of debt which has added nothing to the assets of the company that would increase earnings.

Some of the recommendations in my testimony, if adopted, would not only curb abuses arising from restructurings related to hostile takeover attempts, but would also help to distinguish between a well-advised and ill-advised corporate restructuring. The two steps that are recommended are the following:

"First, those mounting a takeover attempt (and corporations making self-tender offers) should be required to disclose, along with their offer, the principal economic assumptions underlying their asset valuations and projections, the sources of and conditions on the would-be acquirer's financing, the business plans for the target and any plans of the would-be acquirer with respect to the closing or sale of any facilities of the target. Such disclosure would afford communities advance notice of the likely effects of a takeover, and give the communities an opportunity to avoid or ameliorate the adverse effects.

"Second, fiduciaries, including most particularly institutional stockholders, called upon to decide how to respond to a takeover should be permitted to take into account the likely community and social impact of their actions. At present, many fiduciaries feel legally constrained to maximize their short-term profits and to disregard entirely any longer-range or broader interests. Thus, decisions are made which are viewed, even by the decision-makers themselves, as unwise but as compelled by fiduciary obligations. Legislative action is needed to permit fiduciaries to consider, if they wish, a broader range of interests."

QUESTION 2. In your testimony you focus on the negative impact of hostile takeovers. Could you offer recommendations on how we can draft legislation that curbs the perceived abuses attendant to hostile takeovers without having an adverse impact on friendly takeovers and leveraged buyouts?

REPLY:

There has to be a distinction made between friendly takeovers and leveraged buyouts. Friendly takeovers, which do not put a company in play, do not give rise to an escalation of stock prices in the market which then engenders a great deal of debt that becomes the cause of many of the problems and bad effects of the takeover merger. A leveraged buyout, however, also requires the accumulation of stock held by the public for the desired majority control to be achieved. This involves the purchase of large amounts of outstanding stock shares and the incurrence of a greatly enlarged debt, which gives rise to the adverse effects upon the company, the employees, and the community. We believe, therefore, that legislation to be drafted should be aimed at making more difficult the acquisition of large amounts of stock shares which are needed by the hostile takeover initiator who sets off the entire process which also leads to leveraged buyouts under duress. It should be made more difficult by closing loopholes in present laws which help the raider achieve his purpose. I believe that the following recommendations in my testimony would be helpful in reaching this objective:

"First, Regulation G, which was promulgated by the Federal Reserve Board to prevent the excessive use of credit for the purchase or carrying of securities, needs to be tightened so that it applies to stock purchases financed by the use of junk bonds. The loopholes in the present regulation have led to precisely the evil which Regulation G was intended to guard against: market inflation driven by the use of borrowed money.

"Second, the Williams Act should be amended to improve the tender offer process so as to create a more perfect auction, one that is fairer to stockholders of the target company. Thus, for example, it is generally agreed that stockholders should be notified more quickly of a takeover attempt (by lowering the disclosure threshold and shortening the time period for disclosure); that stockholders should be given a longer period of time to respond to tender offers; and that stockholders should not be coerced into tendering their stock by the fear of being shut-out induced by a two-tiered tender offer. We especially commend to the Committee's attention proposals to prohibit two-tiered offers as we view the coercive impact of such offers to be the largest imperfection in the present tender offer system.

"A number of the remaining proposals before the Committee are aimed at enhancing shareholder democracy, either by affording the shareholders of a target operation the opportunity to vote on whether the company should be acquired, by affording the shareholders of acquiring corporations the opportunity to vote on whether their company should acquire another entity, or both. Again, the AFL-CIO joins in supporting these proposals. Given the data showing that acquisitions are dangerous to the health of the acquirer, it seems to us particularly sound to assure the shareholders of acquirers an opportunity to vote on the tender.

"There is one further area in which we believe legislative action is called for to protect shareholders, an area which, to our knowledge, has not received a great deal of legislative attention to date: collusive sales of assets to incumbent management. It has become increasingly common for corporate insiders to purchase either a division of 'their' corporation or the entire corporation through a leveraged buyout. The potential for sweetheart deals in these circumstances is plain. And that potential has been realized in a number of cases as FORTUNE recently concluded in an article entitled, 'Are Shareholders Cheated by LBOs?'

"To prevent these abuses, corporate directors who receive an offer from incumbent management for an LBO should be required to deal with that management in an arms-length fashion. In particular, if the directors elect to consider the offer seriously, they should be required to secure legal and investment advice from advisors who are independent of management. The directors also should be required to seek serious competing offers from outsiders, and should select the offer that is in the best interest of the stockholders and stakeholders in the company. And inside directors cannot be allowed to exercise the principal responsibility for this matter because inside directors face an inevitable conflict of interest. These common sense rules -- which several courts recently have endorsed -- merit enactment as positive law."

QUESTION 3. **While reasonable minds may differ on whether corporate takeovers provide economic benefits or are devoid of economic benefits, are amendments to the federal securities laws the appropriate place to make substantive economic decisions regarding mergers and acquisitions?**

REPLY:

Present laws and regulations governing stock trading facilitate operations whereby a company can be "put in play," by persons seeking to gain control of a target company, or to profit from greenmail, or to profit from selling acquired shares when a leveraged buyout is initiated to avoid a takeover. The injury suffered by communities and workers as a result of these processes which are set in motion under present securities laws are described in my testimony and in my responses to other questions. Amendments to the securities laws that would slow down the action and reduce the potential for relatively quick and large profits by those who initiate hostile takeover attempts would tend to reduce the hostile takeover attempts and sequences of events which often result in widespread personal and community economic injury.

QUESTION 4. **On page 5 of your testimony you note that during the recent wave of takeovers over 80,000 jobs of members affiliated with the AFL-CIO have been eliminated. What percentage of these lost jobs can be directly attributed to hostile takeovers? Haven't job losses occurred at a more alarming rate at companies not subjected to hostile raids such as General Motors, AT&T and IBM? During the last 5 years, a period of great takeover activity, over 9 million jobs have been created and unemployment rates are at their lowest levels since 1980. How do you explain this dichotomy?**

REPLY:

As indicated in my testimony, and in response to previous questions, we have to attribute to the hostile takeover attempts the effects of defenses which such attempts trigger. Therefore, in answering this question, I would include the losses of jobs where the raider was resisted but the process was so costly that, with or without a leveraged buyout, the consequent debt servicing problems led to the sale or shutdown of operating units. In that category, we have had the current, continuing sale and shutdown of stores, regional headquarters, and distribution centers by Safeway. At this time, job losses in two regions total an estimated 9,500; and this number will grow as future similar actions occur in other regions in which the company management is now in the process of launching similar retrenchments.

A similar loss of jobs occurred when the management of Lucky Stores, after a "successful" defense against a takeover raid by Asher Edelman, decided to close down its Gemco general merchandise stores in the far western states in order to have more funds available to place its food stores in a better position to defend against future raids. This decision, reportedly, was also influenced by the Safeway experience. The closedown of the Gemco stores eliminated 14,000 jobs, although the net loss of jobs to the people directly affected was reduced to about 6,000 because under the union contract they had certain rights to employment in other stores owned by Lucky Stores.

Owens-Corning Fibreglass fought off a takeover attempt by the Wickes Company and went through a leveraged buyout which involved the accumulation of a multi-billion dollar debt. A large cutback in operations which followed cut the employed work force in about half, for a loss of 13,000 jobs.

Diamond Bathhurst, a glass products manufacturing firm, acquired three other glass firms in the early eighties and, by 1984, had a total of 22 plants with about 8,000 employees. It closed eight of those plants and now employs 4,000, a 4,000 job reduction.

Goodyear Rubber Company fought off a takeover attempt by James Goldsmith who walked away with $92 million in greenmail. The big cost, however, was in buying up enough shares at rising prices to retain control, so that a debt of about $2.5 billion was accumulated. Subsequent cutbacks in operations and at the Akron headquarters reduced jobs by about 2,000.

In clothing and textile manufacturing, there have been numerous corporate restructurings, mostly through leveraged buyouts. In a number of cases, the leveraged buyout involved members of the existing management group, who after acquisition sold off or closed plants. In some instances, the restructured company then sold off some of its plants to a rival who had similar operations and closed either some of the acquired plants or some of its own plants to reduce competition and jobs. In one case of a successful hostile takeover (of the Graniteville Co.) by Victor Posner, we do not have any knowledge of an employee reduction at the three plants, which employed 4,400 prior to the July 1984 takeover; but it is known from news reports that the company discontinued the provision of public services, such as police protection, road maintenance, garbage pick-up, and street lights in three unincorporated mill towns that grew up around the company plants. The job losses following mergers and leveraged buyouts in the textile and clothing industries for which we do have data total 25,500. Several of the smaller cases involved the loss of a few hundred jobs; but some of the larger ones involved thousands of jobs, such as the loss of 7,700 jobs following the leveraged buyout of Cannon Mills Co. by Pacific Holding Corporation (1982), which closed or sold a number of the Cannon Mills plants; later, in 1986, Pacific sold the bulk of its remaining Cannon Mills plants to Fieldcrest Mill which closed 5 of them and further reduced the work force by 1,500; after Cluett, Peabody & Co. merged into West Point Pepperell, 10 plants were sold or closed for a job loss of 3,300; after Dan River, Inc. went through a leveraged buyout, the work force was reduced by 4,000; after a leveraged buyout of Health-Tex, Inc. in November 1985, there was an employment reduction of 1,300 in the ensuing year as three plants were closed; and after a $1.7 billion leveraged buyout of Levi Strauss by an investor group, including existing management, there was a worldwide employment reduction of 3,300, of which at least half was in the U.S., as the company closed plants in Blackstone, Virginia; Tyler and Corpus Christi, Texas; and Little Rock and Wynne, Arkansas.

In the 1970s, Batus Corporation, a British holding company, obtained control of Gimbels Department Stores, held them for land value rises, and last year shut down the 10 stores in New York City, eliminating 5,000 jobs.

When Lykes Shipping Company took over the Youngstown Sheet and Tube Company a number of years ago, the head of Lykes announced that he would use the cash flow of Youngstown Sheet and Tube, about $100 million a year, as he saw fit. He did and allowed one of the two steel plants, the Campbell Works in Youngstown, to become run-down and outmoded. When the Youngstown Sheet and Tube assets were later sold to Jones and Laughlin, which then was merged with LTV, the latter closed the Campbell works; 5,000 jobs were lost. Subsequently, in 1984, LTV also acquired Republic Steel and has since closed more plants, involving the loss of additional thousands of jobs.

The overwhelming majority of the 80,000 job losses that I cited resulted from either hostile takeovers or the restructuring processes that were set in motion by such takeover merger attempts or threats, including many leveraged buyouts.

As the foregoing data indicate, the hostile takeovers and their aftermaths, such as greenmail and leveraged buyouts, as well as sizeable transactions costs, create huge debts which lead to sell-offs and closedowns of operating units. There is a direct chain of cause and effect. In the case of AT&T, there was another type of cause; namely, a settlement of a government instigated anti-trust suit, providing for the spin-off of 7 regional telephone companies. AT&T had to become a much smaller company; and in the process, it eliminated some functions which it no longer had to perform. The 7 regional firms have combined assets equal to almost six times that of AT&T.

General Motors and IBM are worldwide corporations, and their level of activity has been influenced by the international trading environment. A substantial number of small cars enters the U.S. market from Japan. However, the market in Japan for larger cars, which is not served by Japanese companies, is closed to U.S. producers by non-tariff barriers; namely, excessive, very detailed and time-consuming individual inspections. This makes it impossible to have a large enough volume of cars marketed in Japan to make it an economically feasible operation.

IBM is excluded from marketing its products in the newly industrialized countries, particularly in Brazil and also in the East Asian NICs. Even in Japan, where it has long had production facilities, IBM does not have complete marketing freedom.

It is true that during the last five years, between 1981 and 1986, over 9 million jobs were added in the United States; but in the preceding five years, between 1976 and 1981, more than 11½ million jobs were added. Each of the five-year job growth totals was much closer to the increase in the number of people reaching age 16 during the same five-year period than they were to each other. That is to be expected since, with over 90 percent of the people in the work force normally being employed, the growth of the work force over 16 years of age would be the dominant influence upon the growth of the number employed.

Insofar as the unemployment rate is concerned, it is no great achievement that more than four years after the end of the 1981-82 recession the civilian unemployment rate was finally brought down to 6.3 percent. During 1978, the third year after the 1975 recession, a comparable 5.7 percent unemployment rate was reached. If we compare the annual average unemployment rates for the five years 1982 through 1986, which was 8.2 percent, with that of the preceding five-year period of 1977 through 1981, which was 6.4 percent, the more recent period, in which the takeover merger game -- with all its consequences -- has flourished, we find that the recent period has been the one which yielded the less favorable economic result.

QUESTION 5. Are corporate takeovers more a symptom of other problems in our economy -- a symptom like job loss -- rather than a cause of lost jobs?

REPLY:

Corporate takeover merger attempts and the phenomena they induce -- namely, (1) greatly inflated stock prices, (2) greenmail payments, (3) defense against raiders through purchase of large amounts of its own stock at inflated values by the target company "in play," (4) a leveraged buyout of the target company at stock values that have been inflated rapidly when the company was in play, and (5) the consequent huge amounts of debt accumulated by the target companies -- are followed by shutdowns and the loss of jobs.

The amounts involved are indicated in a table on "The Top 200 Deals" which appeared in Business Week of April 17, 1987. Although the amount shown is the "price," rather than debt assumption, the prices are of a magnitude comparable to the debts assumed in some of the more publicized corporate reconstructions. The price of $4.2 billion shown for the Safeway deal happens to be very close to the debt that was encumbered. Among prices in the top 200 deals in the Business Week list, 2 were over $4 billion; 5 were between $3 and $4 billion; 3 between $2 and $3 billion; 18 between $1 and $2 billion; 58 between $500 million and $1 billion; and the other 114 between $200 and $500 million.

The aforementioned circumstances and the sequence of events entailed in the takeover merger, or the substitute that evolves, definitely identifies that economic syndrome as a cause of significant losses of jobs. It is also a significant factor in increasing the huge outstanding debt that has to be serviced and is reflected in inflationary price increases in the U.S. economy.

QUESTION 6. On page 6 of your testimony you suggest that the restrictions on and penalties for insider trading should be strengthened. What specific recommendations did you have in mind?

REPLY:

It is apparent from recent events that the existing set of prohibitions and penalties have failed to prevent the abuses those prohibitions and penalties are designed to prevent. While the AFL-CIO does not claim special expertise in this regard, the point of our testimony was to join with others, such as Rudolph Giulani, the United States Attorney for the Southern District of New York, in recommending to the Banking Committee that the definition of insider trading be clarified and that the penalties be increased. It is our understanding that the

Banking Committee has requested persons who are expert in this area of the law to develop more specific proposals for the Committee. The AFL-CIO would be pleased to comment on the proposals advanced by these experts.

QUESTION 7a. Doesn't the law require that, in the event of a voluntary termination, all vested and non-vested employees must receive their benefits before a surplus can revert to the coproration?

REPLY:

All benefits accrued to date of termination are vested and are paid to the workers when the plan's age of eligibility for retirement is reached. However, workers often lose future benefits which would have been earned through future service with the employer. Even if the employer replaces the terminated plan with some kind of new pension plan, the worker is unlikely to achieve the benefit level provided by the terminated plan. The result can wreck a worker's retirement security.

QUESTION 7b. If a pension fund is overfunded, then shouldn't the amount of the excess funding be used by the company for more productive purposes? After all, aren't the funds paid into the pension fund paid by the employer?

REPLY:

When a pension plan is included in a collective bargaining agreement, both parties acknowledge that it is, in fact, a part of the wages and conditions of employment which workers are to receive in exchange for their labor. Since the employer contributions paid into the fund have been earned by workers, they actually pay the full amount of the cost. The amounts contributed by the employer to the fund to finance the pension credits accumulated by each worker should, therefore, be an irrevocable payment which the employer cannot withhold or recapture just as an employer cannot withhold or recapture cash wage payments.

QUESTION 7c. Instead of stripping excess assets from the pension fund and thereby "indicating the devaluation of the long-term loyalty of their employees," can't an argument be made that the companies managers are improving the long-term economic posture of the company by maximizing the use of the excess pension fund assets for more productive purposes?

REPLY:

The term "excess assets" as used in the question is misleading since in a plan termination context it has nothing to do with ongoing funding. Ongoing funding is how one goes about accumulating the assets needed to pay benefits at retirement, and it usually reflects future service and salary increases. The term "excess assets" means the market value of assets exceeds the amount an insurer will charge the employer to purchase annuities to provide the benefits accrued to date if a plan were terminated.

Pension asset values compared to accrued liabilities will vary greatly from year to year depending on interest rates, stock market fluctuations, etc. One year there may be "excess assets" and next year the plan may have liabilities that exceed assets. Such fluctuations are normal, and actuarial assumptions take them into account. They pose no problems as long as on average they meet actuarial assumptions. Pension plans are for the long run and should not be terminated because an employer can capture so-called "excess assets" at a particular point in time.

In any event, under a present law, when there is a surplus, the employer can withhold contributions to the fund and use this money in any way the employer chooses.

QUESTION 8. When pension funds are terminated do employees covered by the funds lose the benefits they have earned? How do the sponsors of terminated funds typically ensure that the earned benefits of the employees covered by the fund are protected?

REPLY:

When the plan is terminated, employers are legally responsible only for providing benefits based on service and salary to date of termination. Annuities are normally purchased to cover these obligations and any excess recovered by the employers. They are not responsible for benefits attributable to future service or for benefits reflecting the effect of future salary increases on past service.

The practice effectively freezes the participants' benefit levels, thus frustrating the future right and expectations of active employees and retirees. For example, take a hypothetical case of a worker age 52 with 15 years service at the time of termination who plans to retire in 10 years. This worker might receive one-half the amount the employer promised on which he or she planned for retirement. In addition, benefits are normally not given to the employee until retirement, allowing inflation to erode its value. As mentioned earlier, even if the employer replaces the terminated plan with some kind of pension plan, the worker is unlikely to achieve the benefit level provided by the terminated plan.

QUESTION 9a. Page 3 of your testimony contains a reference to a "Scherer-Ravenscraft" paper. Specifically, to which Scherer-Ravenscraft paper are you referring? Are you aware that many commentators consider the information upon which they base their analysis seriously flawed?

REPLY:

The papers to which I referred in my testimony are Life After Takeover and The Long Run Performance of Mergers and Takeovers, both by Messrs. Scherer and Ravenscraft. It is my understanding that the weight of informed scholarly opinion views the data on which these papers are based as the most reliable available.

QUESTION 9b. The acquisitions of the 1960's and 1970's that Scherer and Ravenscraft studied and found unprofitable were predominately conglomerate mergers. However, many hostile takeovers are the antithesis of these conglomerate mergers because they reduce the more inefficient conglomerate to a more economically viable set of independent or individual concerns. Therefore, why don't you favor the bust up of these unproductive conglomerates and the concentrated power they represent? Shouldn't your real complaint about hostile takeovers be aimed at the corporate leaders who engaged in the practice of conglomeration in the 1960's and 1970's rather than those who are attempting to make these companies more efficient?

REPLY:

The AFL-CIO has long held the view that permitting conglomeratization is unsound economic and social policy and has urged that conglomerate mergers should be strictly controlled by the antitrust laws. It does not follow, however, that once significant resources are expended to affect a conglomerate merger, and the merger takes hold, that it is wise to encourage the expenditure of equally vast sums of time and money splitting up the conglomerate; deconglomeratization in this way is especially questionable where the proceeds go to pay off large debts incurred by a raider or simply to enable the raider to make a quick profit through the purchase and sale of business enterprises.

In any event, the proposals we have advanced are not designed to prevent all hostile takeovers, especially those mounted to achieve economic efficiencies. Our proposals are rather designed to assure that raiders do not make unjust profits in situations where a takeover is not affected, and to assure that investors, workers, and communities are treated fairly in the takeover process.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

WILLIAM WYNN

Q. 1. Do you think that all corporate takeover activity, hostile and friendly offers and leveraged buy-outs should be prohibited?

A. 1. Neither my oral nor our submitted testimony supported prohibition of takeover activity. That is not our position.

Q. 2. If we were to restrict corporate takeover activity, then would you be content to negotiate with managements that are essentially entrenched?

A. 2. Unions will always negotiate on behalf of their members with whatever corporate management takes on that responsibility. We are required to do so by law. Moderate reform of the status quo will not necessarily "entrench" incumbent management.

Q. 3. You mention that the securities laws "effectively sanctify rape and pillage by a few" as long as stockholders are paid off with a sufficient premium. Aren't some of the stockholders members of your union who benefit from takeovers through the premiums realized on the assets held in their pension funds?

A. 3. As a union leader, who annually meets and talks with tens of thousands of American workers, I have yet to meet one who prefers a one-time capital gain on a relatively modest stock holding, to a security stable decent-paying job.

Q. 4. What percentage of Safeway's stock was held either individually or through pension funds by its employees who are members of your union?

A. 4. We have no knowledge of what individual members held in Safeway stock. UFCW members' pensions are vested in hundreds, if not thousands of separate plans. We do not know what the Safeway stock holdings were in our single-employer (non-joint trusteed) pension plans. As of June, 1986 jointly trusteed UFCW pension plans held no Safeway shares.

Q. 5. You complain in your testimony (p. 5) that Safeway's management kept you uninformed about the takeover attempt. What role could you have played if you had been better informed? Couldn't the provision of such information been a part of your collective bargaining agreement with Safeway? Doesn't this example of Safeway's managers inattention to your concerns suggest that entrench managements, without the disciplining effect of corporate takeovers will be even less responsive to labor's concerns?

A. 5. Access to information enables unions to design and propose alternative responses to corporate raids that do not excessively rely on wage and benefit cuts and job destruction. While we can and do seek to incorporate this role in the normal course of labor relations, it is not a mandatory subject of bargaining. In this particular regard, our testimony highlighted employers' present apparent lack of concern for the consequences for their employees, of unlimited corporate raiding.

Q. 6. On page 7, you conclude that substantial numbers of employees would lose their jobs as Kohlberg, Kravis & Roberts sold off assets. Who would be required to work at these spun-off entities once they were sold?

A. 6. When assets are sold, as is the case with the Gemco stores and with Safeway's stores, the buyer is free to fire current employees and to hire any employees he or she chooses.

Q. 7. Do you object to Safeway's payment of greenmail to the Hafts or do you object to the fact that greenmail was paid without the benefit of the union's counsel? Would you rather have to negotiate with the Hafts or Safeway's current management? Is your objection to the Haft/Safeway transaction the manner in which Safeway's present management is using the economic uncertainty created by the Haft/Safeway transaction as leverage in the bargaining negotiations with Safeway?

A. 7. We object to the payment of greenmail for its own sake. Greenmail discriminates against classes of stockholders and simply adds more fuel to a system that is out of control. The Hafts used their $140 million Safeway bonus to launch another attempt on Supermarkets General.

We will negotiate with whatever management is in control.

We have numerous objections to the Safeway transaction. Our major objection is the saddling of an otherwise viable business entity with an insupportable debt, designed to be financed and paid off by appropriating the hard-earned wages of ordinary Americans.

Q. 8. Couldn't the economic crisis that may be confronting Safeway have been averted if Safeway's management fought the Haft's rather than take the easy way out through the payment of greenmail?

A.8. Had the union had an opportunity to play an informed role from the outset, we believe that the economic crisis confronting Safeway could have been significantly mitigated. Once the Hafts put Safeway "into play", there was no other party, save the unions, whose interests coincided with the long-term viability of the company. We believe the leveraged buyout is the major factor in Safeway's turmoil, not the payment of greenmail to the Hafts (see response to Question-7 above).

Q. 9. On page 11 of your testimony you state that Lucky Stores supermarkets in Texas and the Pacific Northwest had been closed or sold by 1985. How many stores were either closed or sold and what were the reasons for the closings or sales?

A. 9. Lucky sold 44 stores in Houston and 24 stores in the Pacific Northwest because, we were told, they were not as profitable as the company would have liked. At that time, the company was expanding its capital investment. Since the Edelman threat and the internal restructuring, as mentioned in my testimony, the Company has cut back its capital investment by one-third.

Q. 10. Why were union overtures for a cooperative approach rebuffed by the managements of both Safeway and Lucky Stores? Why was the union so opposed to either the Haft or Edelman acquisitions?

A.10. The question as to why union overtures were rebuffed should be addressed to management.

Edelman has no experience in managing retail operations and the Hafts' record is dismal. Both parties are well known principally as financial speculators and manipulators. Their track record suggests that they view the firms they target for acquisition either as short-term financial plays or as assets to be milked. Working people's principal interest is adequate income and job security, which comes from stable efficient enterprises. Neither Haft nor Edelman have any history of concern for these.

Q. 11. On page 12 of your testimony you note that the GEMCO stores were closed. What reason was given for their closing? On page 13 you imply that Dayton Hudson will re-open these GEMCO stores. Do you think that Dayton Hudson closed these stores with the intention of re-opening as non-union shops? At that time, would you have the right to organize the employees of the re-opened GEMCO stores?

A.11. It is our understanding that the closing of the GEMCO stores was a condition of the sale agreement required by Dayton Hudson. We do believe that Dayton-Hudson imposed this condition to avoid union contracts. They have a history as an ideologically anti-union firm. We do have the right to organize the employees of the re-opened stores but that does not address the problems of the former employees, our members, who have lost employment, or who, if they seek re-employment, have lost their union contract and accumulated seniority rights. Moreover, since labor laws are being honored more in the breach these days, and given Dayton-Hudson's anti-union attitude, the prospects for reaching the new employees on a fair basis are questionable at best. All the same, those factors have never stopped us from trying.

Q. 12. Isn't your real concern about the Safeway and Lucky Stores transactions that their managers sought to protect their jobs at the expense of the jobs of hourly wage earners who belong to your union?

A.12. It is fair to say that one of our concerns about present conditions is that a few select members of senior management are able to protect themselves at the expense of their workers. Our principal concern is with the quality and stability of jobs.

Q. 13. Since 1980 has membership in your union increased or declined?

A.13. Since 1980 the membership of the UFCW has been stable.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

JAMES E. HATFIELD

Q. 1. Page 8 of your testimony contains a recommendation for the creation of "a review policy for determination of permissibility of corporate restructuring." Could you please elaborate on this recommendation?

A- Q1. It is our view that corporate restructurings ought to be examined with a view to determining their likely impact on jobs, wages, benefits, tax revenues and the like. Corporations should be required to file an economic impact analysis to enable all concerned authorities to take necessary and timely action. Where analysis reveals that a restructuring is motivated by insider profit-seeking such a restructuring could be prevented given appropriate legislation.

Q. 2. Recommendation 6 of your testimony places restrictions on the ability of a company emerging from bankruptcy to engage in a takeover. Can you provide examples of such a transaction other than the one referred to in your testimony? Should there be any exceptions to this rule? Should such restrictions apply to all forms of takeover activity including: hostile and friendly offers, mergers and acquisitions and leveraged buyouts?

A- Q2. The perversion of the bankruptcy laws to serve the purposes of corporate strategies has become widespread. For a time, the bankruptcy laws were the basis for anti-worker union busting companies bent on destroying their contracts. Furthermore, the airline industry provides another example of "bankrupt" Continental taking over a competitor.

Q. 3. Recommendation 4 of your testimony refers to plant closing legislation. Could you provide some specifics with regard to your proposal?

A- Q3. We believe that plant closings are unfair if adequate warning of at least 90 days is not given workers and if provisions for severance pay, retraining and outplacement are inadequate.

Q. 4. Since 1980 has membership in your union increased or declined?

A- Q4. Our union's memberhship has declined since 1980.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
JACK SHEINKMAN

1. Q: By arguing in favor of prohibitions against the use of hostile takeovers, aren't you effectively promoting the type of entrenched managements (the type of which you disapprove, such as Reeves) that are immune from the discipline of the marketplace?

A: Hostile takeovers are a symptom of broader forces buffeting American corporations. The issue is not entrenched management groups vs. outsiders. The issue, more fundamentally, is how does the broader society regulate the American economy's much needed restructing in a way that balances the twin objectives of international competitiveness, while maintaining a company's social responsibility to its employees and to the community in which it operates. Hostile takeovers often cause the most disruptive and unproductive forms of restructing. This process in turn fails to address important corporate social responsibilities and also results in creating an environment in which international competitiveness is rarely considered.

2. Q: Page 3 of your testimony contains a reference to Reeves now Schick's huge fixed interest costs as posing a threat to the company's future. What is the interest rate of these fixed interest costs? How do the interest costs to which you refer compare to the costs of equity which Schick could have raised and used to acquire Reeves? What is the current debt/equity ratio for Schick's competitors in the textile industry?

A: According to documents filed with the Securities and Exchange Commission, the total long-term debt of Schick, Inc. rose from $35 million in 1984 to $52 million in 1985 and to $277 million in 1986. While some of the increase in debt is reflected in the cost of expanding Schick's other operations, the overwhelming majority of this debt ($242 million) was taken on to finance the acquisitions of Reeves Brothers. This acquisition financing was in the form of a $100 million term loan and $142 in junk bonds. Interest on this long term debt is as follows:

	Long-Term Debt	**Interest Rate**
1.	Notes payable to bank under a $100 million loan agreement	8-½%
2.	Senior notes, $72 million	12-½%
3.	Senior subordinate debentures, $54 million	13%
4.	Subordinated Debentures, $16 million	13-3/4%

It is not possible to calculate how these interest costs would compare to equity costs without additional financial information from the company. I respectfully refer you to Schick, Inc.'s management for this information.

The current debt/equity ratio at Schick is 16.9 to 1. Debt to equity ratios for the textile industry are not available.

A readily available, conceptually equivalent measure of leverage levels is the ratio of debt to net worth. This data is presented for lines of business somewhat different from Schick's, which is a diversified manufacturing company. With this limitation in mind, the relevant comparisons are:

	debt/net worth
Schick, Inc.	.746
Weaving Mills	.326
Plastic Products	.364

3. Q: Page 4 of your testimony contains a statement regarding the possibility that "if Schick and Reeves miss an interest payment the bankers will be living in their house". This statement seems to conflict with your testimony that these were junk bond financed transactions. Wouldn't the bondholders, rather than the banks, be adversely affected by a default? In any event, wouldn't the bondholders or a bank attempt to implement a financial restructuring of the debt before they are willing to push the company into bankruptcy?

A: The use of the phrase "living in their house" was intended to highlight the differences between equity capital and loans or bonds. A term loan and a bond are similar in several respects. Both are investments with a contracted rate of return. The capital is invested for a fixed length of time and neither have claims of ownership on the corporation. In the event of a default, banks and bondholders stand in line ahead of the equity participants. In most cases, if a company misses an interest payment, it is technically in default of its loan. Missing a dividend payment often results in angering a company's stockholders, and given that stockholders are also owners, may lead to a change in management.

4. Regarding your comments on pension funds:

Q: (a) Doesn't the law require that in the event of a voluntary termination, all vested and non-vested employees must receive their benefits before a surplus can revert to the corporation?

A: The law does require that all employees must receive current benefits before a surplus can revert to a corporation. However, according to Reeves Brothers Summary Plan Description the company essentially promises its workers that such a surplus will benefit the employees.

> "The pension fund will increase through Company contributions and gains on fund investments. Of course, the pension fund will also reflect any losses that may be incurred on investment of the fund and will be reduced by benefit payments".

It seems only fair that if the workers' pension must be put at risk in the event of a downturn in the value of their funds' investment, they should also be entitled to benefit from the increased value of such funds, which become the surplus.

Q. (b) If a pension fund is overfunded, then shouldn't the amount of excess funding be used by the company for more productive purposes? After all, aren't the funds paid into the pension fund paid by the employer?

A: It is my conviction that company contributions made to pension plans are "deferred wages" and the funds placed within a pension plan are to be used for the benefit plan participants. Furthermore, we believe the key factor to production in any manufacturing company is a motivated and committed labor force. I can see no better way to ensure long-term productivity than to effectively reward the loyalty of experienced workers with retirement security. We don't feel that taking surplus funding from the pension plan of a company which is, and has been for many years, financially sound, positively impacts a corporation.

Q: (c) Instead of stripping excess assets from the pension fund and thereby "indicating devaluation of the long-term loyalty of their employees", can't an argument be made that the company's managers are improving the long-term economic posture of the company by maximizing the use of the excess pension fund assets for more productive purposes?

A: See answer to Question 4 (b) above

5. Q: When pension funds are terminated, do employees covered by the funds lose the benefits they have earned? How do sponsors of terminated funds typically ensure that the earned benefits of the employees of the fund are protected?

A: When sufficient defined benefit pension plans are terminated, employees end up recovering only 65% of the benefits they have earned, according to a 1984 Department of Labor Study. Employers typically ensure earned benefits through the purchase of annuities from insurance companies. However, plan participants lose the potential for receiving future benefit increases. Pension benefit formulas are often improved over time and the possibility for obtaining any pension improvements is lost once the plan is terminated.

6. Q: Since 1980, has membership in your union increased or declined?

A: Our membership has declined, as has the entire workforce in our union's respective industries. From 1980 to 1986, approximately 6,000 textile and apparel plants have closed and 350,000 textile and apparel workers have lost their jobs as a result of these closings. 51,000 footwear workers have been put out of work during this period. Job losses stem primarily from the recent steep penetration of foreign imports in these industries. Apparel imports, which comprised 35% of the domestic market in 1980, held a 51% market share in 1986. In footwear (non rubber), imports rose from 50% in 1980 to an 81% market share in 1986.

Jack Sheinkman
Secretary-Treasurer
Amalgamated Clothing &
Textile Workers Union
May 12, 1987

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

JOHN J. BAVIS

April 23, 1987

Mr. Steven B. Harris
Counsel, Committee on Banking,
Housing, and Urban Affairs
SD546
Washington, DC 20510

Dear Mr. Harris:

This is in response to written questions posed to me by Senator D'Amato following my testimony before the Banking Committee on April 8, 1987.

Senator Proxmire requested that I reply directly to you.

Question #1

Prior to the company's sale to Texas Air Corporation, Eastern's employees approached management on several occasions. What were the reasons that were given for the Board refusal to permit the employees to buy as you call it "your troubled airline?"

Answer:

On various occasions prior to the sale, representatives of the employee groups indicated to the Board of Directors, not management, that they would be interested in purchasing the airline. In each instance they were told that the airline was not for sale.

Further, when the offer from Texas Air was first brought before the Board of Directors, Mr. Charles Bryan, a member of the board and President of the International Association of Machinists and Aerospace Workers, District 100, reaffirmed employee interest in purchasing the airline and asked if he could formulate a counter-proposal. The request was dismissed out-of-hand by the board, citing the need to act swiftly to effect the sale since Texas Air had put a deadline on the offer for acceptance or rejection. Further, various members of the board doubted the employees ability to secure financing for the purchase, while others challenged Mr. Bryan's ability to make an offer on behalf of all employees.

On two subsequent occasions, Mr. Bryan asked for the opportunity to make a bid for Eastern. His proposals were rejected based on a no-competitive-bid provision in the Texas Air agreement.

Parenthetically, when the subject of an employee buyout of the airline was first presented to the Board of Directors, long before it was approached by Texas Air, the board took immediate action to prevent any kind of hostile takeover, adopting a "poison pill" consisting of a new issue of stock and a "Chartered Board" provision which precluded a tender offer not in concurrance with the wishes of the board.

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SCHEDULE WITH SAFETY - AFFILIATED WITH AFL-CIO

Question #2

How would the employees have financed the acquisition of Eastern Airlines and at what price did they propose to pay for Eastern's shares?

Answer:

Our purchase plan consisted of 5 key elements:

1. Wage givebacks approximating 25% of salary from all employees.
2. Bridge financing from the employees' credit union.
3. Guaranteed productivity increases written into the terms of each employee group's contract.
4. A wage increase freeze for the duration of the financing package in order to satisfy lenders
5. Conventional financing of approximately $500 million in order to liquidate some existing debt and provide operating funds. Our ability to secure these funds, having met the other 4 conditions above, was assured by our investment banker.

The Employee Coalition proposed to purchase the airline for $10.25 per share, all in cash, as opposed to the Texas Air offer of $10 per share -- $6.50 of which would be in cash and $3.50 in junk bonds. Under the agreement with Texas Air, Eastern paid 51% of the cost of its own acquisition.

Question #3

Assuming the employee purchase would have been made through junk bonds or debt financing, wouldn't the same economic pressures, which you state are now facing Texas Air Corporation, be placed upon the shoulders of the employee/owners? Do you think Texas Air Corporation is better able to address these economic burdens than employee/owners?

Answer:

In order to facilitate the purchase by Texas Air, Eastern, though already faced by massive debt, borrowed an additional $500 million, $121 million of which was used to pay acquisition costs. In incurring this additional debt service, Eastern appreciably diminished the value of its assets and diluted the value of the company's stock, impacting heavily upon the 20% of that stock owned by employees.

We believe employee/owners would not now be facing the economic pressures claimed by Texas Air. A study of the thousands of Employee Stock Ownership Plans currently in effect in America shows that workers are willing to endure more hardship and sacrifice more when they are the ultimate beneficiaries of their efforts.

3
D'AMATO — BAVIS

It is my contention that our current Texas Air management is creating the economic problems at Eastern through such tactics as the spinning off of profitable assets and lease-back arrangements at exhorbitant rates, resulting in a drain in both assets and profits. It has also imposed onerous work rules which have resulted in the early retirement or resignation of over 600 pilots since Texas Air took control, causing major scheduling problems and affecting on-time dependability in the minds of our passengers.

If employee/owners were running the airline, we would be intent on expanding it profitably, rather than shrinking it by selling gates and planes, eliminating routes, transferring assets to other companies within the corporation, or provoking discontent in employee ranks.

If I can be of any further service to Senator D'Amato or yourself, please do not hesitate to call. I thank you and the Senator for your interest.

Cordially,

John J. Bavis Jr.

John J. Bavis
Chairman, EAL MEC

JJB/jz

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

CHARLES BRYAN

Q. 1. Do you support the proposed takeover of United Airlines by the Airline Pilots Association? Won't ALPA be subject to the same economic pressures with regard to the surviving company as any other successful bidder?

A- Q. #1 - In answer to question #1, I have no direct responsibility for the employees of United Airlines; however, I would highly recommend any program which would embrace equal or balanced ownership by all employees of any corporation. As to the second part of question #1, if ALPA single-handedly purchased United Airlines, I would not be in a position to predict the effect of having one employee group have full ownership which could lead to conflicts of interest and priorities.

Q. 2. As a member of Eastern's Board of Directors and the Finance Committee you must have been familiar with the welfare of the company. How many employees were laid-off or released since 1980? Were these lay-offs or releases the subject of hostile takeovers or the economic turmoil the industry experienced as a result of deregulation? Since 1980, how many years has Eastern earned a profit?

A- Q. #2 - The number of employees grew from 40,000 in 1980 to 41,100 by the end of 1985 and then was cut back to 40,272 by the end of 1986, for a net increase over the six year period of only 0.7%. During the same period, however, Revenue Passenger Miles, the standard measure of output in the industry, grew from 28,227 million to 34,887, or an increase of 23.6%, and total revenues grew from $3,452.5 million to $4,401.6, or an increase of 27.5%.

Therefore, while Eastern's net level of employment was virtually flat during this period, its output and revenues grew by approximately one-quarter. This dramatic increase in productivity was achieved because of an innovative labor/management cooperation program negotiated in late 1983 and implemented in 1984. Employees invested their wages in company stock, implemented cost savings programs, placed representatives on the board of directors, and reviewed key management planning and investment decisions.

The results of this cooperation were dramatic. While Eastern faced rising losses from 1980 through 1983, reaching a net loss of $183 million in 1983, the losses were cut in 1984 to $37.9 million and from February through August 1985, the company produced unprecedented earnings of $168 million. However, Eastern finished 1985 with net income of only $6.3 million after management elected to scuttle its program of labor/management cooperation in the fall of that year and initiated a series of devastating decisions which undermined the company's profitability. These decisions set the stage for the takeover by Texas Air and in 1986, without the benefits of labor/management cooperation, Eastern returned to its usual performance, losing a total of $130.8 million.

Finally you should note the decline in employment once Texas Air was in command. Major layoffs began in the fall when Texas Air publicly stated that it already controlled more than 50% of Eastern's stock. On September 2, 1986 management announced the termination of 1,534 employees throughout the system. More recently, on April 17, 1987, management announced that they intended to lay off 259 maintenance employees in several stations.

Q. 3. You mention that you owned 5,000 shares of Eastern; how were these shares acquired? What was the average price per share which you paid for these shares? What price did Texas Air Corporation pay for these shares?

A- Q. #3 - The reason for my estimating 5,000 shares as my holding of Eastern Common was that for approximately two years Harris Trust (Asset Trustee) and Martin Segal Company (Plan Administrator) consistently promised but never responded to my inquiries as to the total number of shares, dates of purchase and prices paid through a 401(K). I deducted 15% from my income for more than two years to be exclusively used to purchase Eastern Air Lines Common stock, and I had great difficulty in complying with S.E.C. requirements to report my holdings as a Board member of Eastern Air Lines because of that lack of cooperation. It was only after I advised Harris Trust that my response to your question as to my Eastern Air Lines ownership would not be completed and the Congressional record of Senator D'Amato's question as a member of the Proxmire Banking Committee would reflect that explanation that they immediately provided detailed answers of my 401(K) purchases.

The total shares purchased in that fashion was 2,634 shares at a variety of prices totalling $18,593 which resulted in $7.06 per share for the average price. I held 200 shares from direct purchases, for a total price of $1,337.50 for an average of $6.68 per share. In January of 1986, to set an example of a major employee direct purchase program for Eastern Air Lines Common stock, I converted and invested all of my IRA, $8,200, to purchase 1600 shares of Eastern Common at $5.125 per share. The total of my holdings at the time of the sale was 4,434 shares, the total purchase price of $28,130.50 for an average price of $6.344 per share. I received $6.25 cash per share from the Texas Air Corporation acquisition of Eastern Air Lines, and a preferred stock for the remainder of the $3.75 for the $10.00 offering for Eastern Air Lines. That preferred stock is listed on the American Stock Exchange as Eastern Air Lines Preferred - $2.84, and has never been valued at a level to achieve the $10.00 offering price.

Q. 4. At the time of the deal between Eastern's Board and Frank Lorenzo (February 24, 1986), what percentage of Eastern's stock was owned by the employees? Why did the employees agree to sell this stock to Texas Air Corporation?

A- Q. #4 - The employees of Eastern Air Lines, as a result of the 1984 Wage Investment Program, achieved 25% ownership of all Eastern Air Lines Common stock. Based on information from previous efforts I had made to run for the Board of Directors since 1980, I would estimate that the employees of Eastern Air Lines owned a minimum of 5% of Eastern Air Lines Common stock through various stock purchase programs, direct purchases, etc. prior to the 1984 Wage Investment Program. The 25% ownership directly resulting from the 1984 Wage Investment Program was diluted to 20.7% when Eastern Air Lines issued 12.8 million new shares of stock in July 1985.

In January of 1986 there was a major program announced by the unions, and mass public meetings were held, to encourage all employees to maximize their ownership in Eastern Air Lines to increase their voice in the governance process of the company in an effort to preserve the very successful programs which had generated the unprecedented profits of $168 million net and nearly $300 million operational profits in the first seven consecutive months during the year leading up to the sale to Frank Lorenzo.

Eastern refused to cooperate with written requests for information to determine our level of employee ownership but we estimate conservatively we had a minimum of 30% ownership and very possibly more than 35% ownership by the time the Board of Directors created a "poison pill" on January 31st, and the "lock-up" for Lorenzo on February 24th.

Our attorneys from Skadden Arps who were advising us up to the time of the sale were present at the Board of Directors meeting when the company was sold and advised me that the "lock-up" contract for the sale to Texas Air Corporation made it impossible for the employees to do anything to stop the transaction unless we were successful with a bust-up lawsuit in court. Their advice was that it would serve no purpose for the employees to hold on to their stock at that point because the "lock-up" provisions of the sale contract gave Frank Lorenzo an advantage which would be impossible to overcome. I did not agree with that advice at the time, but predicated on the reputation of that prestigious firm, we did not interfere or discourage the employees from liquidating their holdings in the months subsequent to the contract between Eastern Air Lines and Texas Air.

My instincts, which I expressed at the time, were that we should have taken full page ads in the major financial publications and maximize our encouragement for the employees or other allies to expand their holdings at Eastern. I am firmly convinced that I should have followed my instincts and was ill-advised with regard to a strategy to preserve the employee ownership of Eastern Air Lines. The lawyers consistently told us that the employees really had no choice at that point and it would be an exercise in futility to attempt to hold the stock and overcome the "lock-up" through the marketplace.

Q. 5. What reasons did Eastern's Board offer for rejecting the Employees' offer to purchase the airline?

A- Q. #5 - The Board of Directors on the night of the sale announced a three step sequence of priorities that they would try to (in their terms) (1) fix the airline by reducing all employees' wages and benefits; (2) sell the airline, or (3) "tank it" (file Chapter 11 or possibly Chapter 7). The Borman and Board of Director Executive Committee's battle cry became, "Fix it, Sell it or Tank it".

When the motion to sell was about to be voted on at approximately 1:00 a.m. on February 24, I asked to recess and I instructed my attorneys from Skadden Arps to get two Committee Chairmen (Audit and Finance) from the Board and advise them I would not open the Collective Bargaining Agreement; however, predicated on the performance of our current Chairman being replaced, we would consider labor cost reductions which would have met the criteria established to avoid the sale. The Board recessed and caucussed for approximately an hour and a half until after 2:30 a.m. to privately deliberate over that offer. When they returned they rejected that opportunity and later publicly stated that they could not do that to their "Chairman", and voted to sell the company.

On August 29, 1986, after the DOT's initial rejection of the merger, I made the first of several offers on behalf of the employees. This was a cash offer of $10.25, which was superior to the terms of the Texas Air/Eastern Air Lines merger agreement. Eastern's counsels' position then was that I had no authority from the employees to make such an offer and no evidence of financing capabilities and they would not take it under formal consideration because of their self-imposed "lock-up" and provision for no solicitation of other offers contained in the contract.

Immediately following the rejection of my original offer we aggressively developed a formal Coalition between the pilots, the fight attendants and the ground employees and ultimately developed a commitment from an investment banking firm to raise the necessary money and asked Eastern on October 15, 1986 to accept a motion to the Board that the employees be given 60 days to accomplish the necessary investment banking commitments for our superior offer.

Two days later on October 17, a very brief (about seven minutes) telephone Board meeting was held, I thought for the purpose of voting on my resolution; however, the only action of that meeting was to install Frank Lorenzo as Chairman of the Board and Phil Bakes as President of Eastern Air Lines and member of the Board. That action was taken approximatey six weeks prior to the shareholders meeting to approve the sale. The Board of Directors later rejected my resolution and we continued pursuing our right to purchase Eastern through a court action.

Several days prior to the Shareholders meeting, the Employee Coalition, supported by a letter of commitment from our investment banker, increased our cash offer to $11.50 per share. The Board of Directors said they did not have confidence in our ability to finance, and because of the" lock-up" which had already given Texas Air majority ownership and because of the no solicitation provision of their contract, they rejected the $11.50 offer.

Q. 6. If Eastern's employees had been successful in acquiring the company, how would they have financed the purchase of the shares that they did not own or control? If this acquisition would have been financed through debt or junk bonds, wouldn't the employee acquired company be subject to the same or even greater pressure to service its debt as presently confronts Texas Air Corporation? Is Texas Air in a better position to service this debt than the employees of Eastern Airlines?

A- Q. #6 - From the data presented in response to Question 2, I believe that it is evident that labor/management cooperation based on employee ownership can be a powerful weapon in resurrecting a financially troubled and poorly managed company.

There is no doubt that an employee buyout would have also generated a heavy load of debt for Eastern. On the other hand we would not have had to also bear the debt burden of Continental, People Express, Frontier and New York Air, which is also considerable.

The issue here is not so much the existence of the debt, but under what scenario is the company most likely to generate the kind of employee spirit and productivity which will translate into the cash flow required to pay the debt off.

Under the terms of an ESOP buyout, employee sacrifices translate into direct ownership of their company, with the prospect of long-term returns on their investment once the company has been turned around. Much to the contrary, Lorenzo wants to cut Eastern employees' wages and benefits by $490 million to pay off the debt without employee ownership and for the benefit of Texas Air stockholders, particularly its controlling stockholder, Jet Capital Corporation of which he is the majority owner.

An article in the most recent Business Week (see enclosed) is a telling reminder that even those employees who sided with Lorenzo in his bankruptcy strategy to manage Continental are now weary of his autocratic style, his absolute control, the subtle intimidation and the sub-standard level of compensation. The quality of Continental's service in recent months is good evidence of their discontent.

If Lorenzo's strategy is losing the support of those employees who know him best and supported him at the start, it is a foregone conclusion that he will never win over the goodwill and dedication of employees who did not want him at Eastern in the first place and are now faced with management threats of cutting their wages and benefits by $490 million.

Recent filings by Texas Air with the Securities and Exchange Commission (see attached report to Congressional representatives) make it crystal clear that Lorenzo has no intention of sharing control of his companies with anyone, least of all the employees. With such unilateral control and total disregard for the welfare of his employees and their families, Lorenzo will fail in achieving the necessary harmony and hard work which will be required to salvage Eastern Air Lines.

Q. 7. Since 1980, has the membership in your union increased or declined?

A- Q. #7 - In 1980 District 100 of the International Association of Machinists and Aerospace Workers represented 16,876 members in the airline and related industries, of which 13,174 were employees of Eastern Air Lines. By 1987, our total membership had risen to 16,037, but the number of our members employed by Eastern had declined to 13,080. This last number, however, does not reflect the recent decision by the new Texas Air management to lay off maintenance employees (see response to Question 2).

I am most grateful for the added interest evidenced by these follow-up questions by Senator D'Amato and will be available as a number one priority to answer questions anytime or to provide any future testimony.

Very truly yours,

Charles E. Bryan

Charles E. Bryan
President and General Chairman
District 100, I.A.M.A.W.

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In our continuing efforts to keep you appraised of developments at Eastern Air Lines and its parent, Texas Air Corporation, I would like to share with you some key points which have just emerged from recent Texas Air filings with the Securities & Exchange Commission (SEC).

It is becoming more evident every day that one man, Frank Lorenzo, would like to decide the appropriate standard of living for all airline employees. Management has hyped the union-busting buzzword "union-free", but that just means "Lorenzo-captive."

If anyone still has any doubts about the unilateral powers of Frank Lorenzo, they need only read the most recent filings by Jet Capital Corp. and Texas Air Corp. with the Securities & Exchange Commission.

Lorenzo controls Texas Air, Continental, Eastern, People Express, Frontier, New York Air and all the other proliferating entities of the Texas Air complex through Jet Capital Corp. Much of Jet's power is based on its 100% ownership of a special class of Texas Air stock, Class A Common, which has five votes for every share outstanding.

But there seems to be no limit to Lorenzo's quest for more power. New information in Texas Air's most recent Proxy Statement, dated April 22, 1987, discloses that Texas Air's stockholders are being asked to authorize an amendment to the certificate of incorporation which will double the voting rights of each share of Class A exclusively held by Jet Caapital from five votes to ten votes per share. This will effectively increase the voting power of Jet Capital to 34.1% and according to the Proxy Statement:

> "...[This] should be enough to effectively control the election of directors and other matters presented to the stockholders for their vote" (page 23).

The Proxy Statement also discloses that Frank Lorenzo's ownership of Jet Capital has risen to 50.7%, giving him absolute majority control.

We understand that certain institutional investors are particularly incensed by this move by insiders to entrench their control. But do they stand a chance for garnering support against this amendment?

In earlier filings with the SEC on March 25, 1987, before the new Texas Air amendment, Jet Capital had already stated that:

> "...Jet has the power to exercise a controlling influence over matters submitted to the stockholders of Texas Air and over the election of the 75% of the Texas Air board of directors as to which the Class A Common Stock is entitled to vote. No other stockholder has sufficient voting power or other influence in the management of Texas Air to rival Jet's influence over the management of Texas Air to rival Jet's influence over the management and policies of Texas Air" (Jet Capital, 40-APP, March 25, 1987, p. 6).

As Frank Lorenzo has outright control of Jet Capital Corp, the results of the vote on the Texas Air amendment are themselves a foregone conclusion.

The pretense of an open and democratic vote is such a sham that the outside directors felt compelled to state in the Proxy that:

> "...to the extent that the Class A Vote Amendment makes it more likely that directors ...and management will retain their existing positions, it could be argued that the incumbent Board and management have a potential conflict of interest in proposing the amendment" (p. 24).

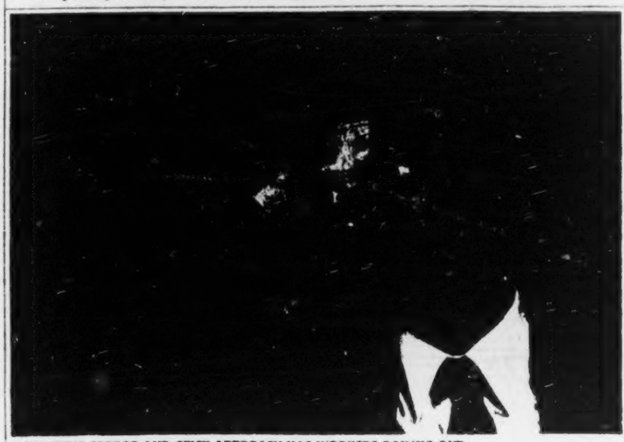
They even warned that this Amendment might have to be cancelled if attempts by the securities exchanges, the National Association of Securities Dealers, the Securities & Exchange Commission and legislation introduced in Congress succeed in establishing a uniform one-share, one-vote standard for all domestic equity securities traded on the major exchanges.

This manipulation of controlled voting is just the same version of democracy which Lorenzo conceived in his early days as a student at Columbia University. At that time he applied the same principles to the elections of the student governing board. He was caught rigging the elections by voting twice, was banned from voting ever again in a Columbia election, was forced to resign his dorm council post and was cited by the Columbia Daily Spectator for his "lack of any semblance of self-respect and honor." His Columbia days earned him the nickname "Frankie Smooth Talk" (Texas Monthly, March 1987).

AIRLINES

WHAT IT'S LIKE TO WORK FOR FRANK LORENZO

Lousy, say many Continental pilots, who take home less than half the industry average



LORENZO'S CARROT-AND-STICK APPROACH HAS WORKERS BAILING OUT

When "Mike" joined Continental Airlines Inc. as a pilot in 1984, he knew that working for Chairman Frank A. Lorenzo would be no picnic. The airline had gone through an acrimonious labor dispute the previous year, when Lorenzo used Chapter 11 bankruptcy to break the carrier's union contracts. Mike is glad to have a job that pays $36,000 a year. But he also realizes that he makes much less than pilots at other big airlines, and now he wants out. Like many fellow workers, Mike no longer believes Lorenzo's promise that employee sacrifices will be rewarded as Continental recovers from bankruptcy and grows. "Management hasn't shared anything" with employees, he complains, adding that he's now interviewing with American Airlines Inc.

Since 1983, Lorenzo has succeeded beyond anyone's expectations in keeping employees such as Mike working under what the company calls "emergency" conditions—at wage rates that often are half of industry averages. His secret: a carrot-and-stick approach to his largely nonunion work force that combines the lure of a shining future with what one 20-year company veteran characterizes as "subtle intimidation." Fear of retaliation led Mike—along with most of the 30 or so other employees BUSINESS WEEK interviewed—to request anonymity. But eight months after Continental emerged from bankruptcy, many employees say they're losing patience.

JUMPING SHIP. The result is a dilemma for Continental, which Lorenzo controls as chairman of parent Texas Air Corp. He doesn't have to worry about departures of workers such as flight attendants, who can be replaced with relative ease. But good pilots and mechanics are increasingly difficult to find, and Continental can't expand if they keep abandoning ship. A big pay hike is one obvious way to keep them. This also would help ward off the Air Line Pilots Assn. (ALPA), which is launching a multimillion-dollar campaign to reestablish its Continental chapter. But the company can't let labor costs rise much without hurting its financial results. It turned an $18 million profit last year on revenues of $2 billion. Analysts estimate that it lost about $40 million in the first quarter of 1987.

The strains at Continental are also complicating Lorenzo's strategy at Eastern Air Lines Inc., which he bought last year. Lorenzo, who refused to be interviewed for this story, has demanded pay cuts from Eastern's three unions and threatened to transfer Eastern's jobs to Continental—giving them to new, nonunion hires if workers don't go along. But that threat looks increasingly empty if keeping Continental fully staffed is already a problem.

Nonunion pilots, in fact, are Lorenzo's big worry at Continental, which includes the former New York Air and the remnants of Frontier and People Express Airlines. A growing scarcity of pilots was part of the reason Continental raised pilot pay scales slightly two years ago. It is now planning another raise, but only for captains. Starting June 1, they'll get raises of 12% to 20%.

That still won't bring Continental close to par with other airlines, however. The industry average for a captain with 10 years' experience is $108,000, compared with $52,500 at Continental. Even ardent Lorenzo supporters are concerned. "Most of us are proud of what the airline has done," says Steve Keller, a three-year Continental captain and one of the few employees willing to be named. "But the company has got to do right by us."

Company veterans also complain of the fatigue and stress of flying up to 90 hours a month. Pilots at other major airlines fly about 80 to 85 hours a month, but some 5% of that is time spent on the ground—which Continental doesn't count. "I might get 35 minutes' pay for flying from Denver to Colorado Springs and then sit on the ground for five hours at no pay before flying back to Denver," gripes a 20-year Continental veteran, who joined strikers in 1983 but returned to work after 45 days. "If I continue, I'll be so fatigued I won't make it to age 60."

Some pilots claim that Continental has set up an incentive plan to make them more productive. The plan stipulates that "if we get the sick calls down, everyone shares in a bonus," one pilot says. "It doesn't make sense from a safety standpoint but it does from an economic standpoint." The company denies that there is any safety impact.

Other employees have similar complaints. Flight attendants are paid $13 an hour for a guaranteed 65 hours of flying time a month—$10,140 a year. They also must be on call—for $1 an hour—whenever the company tells them they might be needed. "We're treated like cattle, just like the passengers are," says one attendant, who figures her real pay averages out to $4.75 an hour. "If you hate your boss, you're not going to work your best." She estimates that about 20 of Continental's 4,000 flight attendants and 50 of its 6,000 airport agents leave each week. "Continental knows that in a matter of weeks it can get good-looking, hard-working bodies," one pilot says of flight attendants. "It expects that they'll do the job one or two years, then burn out and leave."

Some pilots say they're ready to leave, too. The industry's seniority system makes it harder for them to move, even though jobs are available at other carriers. At other companies, a pilot's pay typically rises as he qualifies to fly bigger planes, which is primarily a function of seniority at one company. Seniority also gives a pilot increasing control over which routes he flies. A captain making $55,000 a year flying a Continental 747 may find a job at United Airlines Inc. But since that job would be at the bottom of United's seniority list, it would take five years to get back up to $55,000.

Nonetheless, some Continental pilots feel it's now less of a sacrifice to switch than to stay. ALPA says Continental is losing 30 of its 3,800 pilots every month. Richard J. Hillman, the airline's vice-president for flight operations, says the company is losing pilots at only half that rate. So far, he insists, "we have had no big attrition problems." But United says that a number of its recent hires came from Continental and Eastern. "I'd say that a minimum of 200 Continental pilots have interviewed at Northwest, United, and American," says a Continental captain with 10 years' experience.

DECLINING QUALITY. Continental has also been losing mechanics, who are about as scarce as pilots. Hillman concedes that because many mechanics were leaving, the company was forced to raise the pay of senior mechanics by 5% last year, to about $15 an hour. He says that the problem is now over and that mechanics' attrition rate has dropped from 20% a year in 1986 to 3% today. But starting mechanics make $10.80 an hour vs. up to $14 an hour at other airlines. "Turnover of mechanics is still 10% a month in my city," claims a Continental mechanic in Denver, and pilots complain about the quality of mechanics. "People come on board a DC-10 and don't know how to solve a problem," says one. Continental says that its mechanics are qualified.

CONTINENTAL'S JUMBLE OF PILOTS

	Number of pilots
DIRECT HIRES:	
DIDN'T STRIKE	550
STRUCK AND RETURNED	355
HIRED SINCE NOVEMBER, 1983	1,270
FROM ACQUISITIONS:	
PEOPLE EXPRESS	920
FRONTIER	390
NEW YORK AIR	315
TOTAL	**3,800**

DATA: CONTINENTAL AIRLINES INC., AIR LINE PILOTS ASSN.

Pilots say the expertise of other ground personnel is spotty as well. One remembers a recent trip when the jetway operator goofed and passengers had to use the rear stairs instead of the covered ramp. The pilot complained to the supervisor, who responded: "I can't get better people on $5.77 an hour."

STRIKE SCARS. ALPA believes the pilots' frustration indicates that the time may be ripe for the union's return. But ALPA has much history to overcome. Many Continental pilots were alienated by its desperate attempt to make them honor its picket lines in 1983. Strikers spat on strikebreakers and called them names. And some pilots who walked off the job were accused of violence against fellow pilots who kept flying.

To overcome this animosity, ALPA is taking an unusual approach. The union's national headquarters has promised $2.5 million to its Eastern pilot group. Some of this war chest is funding a buddy system that pairs each of 4,000 Eastern pilots with a Continental counterpart. The Eastern employee will initiate a casual meeting to soft sell the other pilot on ALPA. Already, 400 Eastern pilots have been trained in the art of friendly persuasion. The union says that phones should start ringing this month. "When [new Continental pilots] get over the euphoria of flying an airplane and see the needs of their family, they'll want to organize," argues John J. Bavis, the ALPA chairman at Eastern.

CONTINENTAL'S PROBLEMS MAKE IT HARD FOR LORENZO TO CUT EASTERN MECHANICS' PAY

FEAR AND LOATHING. ALPA will find it tough to unite the airline's pilot factions, however (table). Continental's piecemeal growth has disrupted the balance of pilot seniority, leading to divisive infighting. The purchase of People Express, for example, added 295 captains, thus slowing the advancement of younger Continental pilots. It also angered up to 150 other People Express captains who were demoted to first officer in the process. Still more disruption came after some 300 returning strikers were placed ahead of new hires in seniority. "I assume Frank Lorenzo wants the pilot group to be as divided and confused as possible," says one pilot.

Fear of management will make ALPA's task harder. Pilots say they feel closely watched. Indeed, Continental's Hillman says he knows exactly how many pilots attended a recent open house sponsored by Eastern pilots: 10 over a five-hour period. Such scrutiny makes pilots afraid to endorse the union openly. "I'd have no protection if they decided to put me through the ringer on a proficiency exam," says one pilot who likes ALPA. The union expects such pressure to intensify as its unionization drive picks up. "It will be a knock-down-drag-out fight," says Henry A. Duffy, ALPA's president.

But Lorenzo can't push his pilots too hard if he wants to continue growing. So far he's been able to sign up pilots from relatively low-paying jobs in commuter and corporate aviation. The company says such hires constitute more than 60% of the 1,270 new pilots Continental has signed up since 1983. However, Hillman says that Continental wants to add 40 planes this year and hire 1,000 new pilots. This could prove difficult even if it really is losing only 15 pilots a month.

Lorenzo started over after the strike with a lot of employee goodwill. Much of this now seems to have been squandered. And that may make it increasingly hard to maintain his low-fare empire.

By Jo Ellen Davis in Houston, with Pete Engardio in Miami by Robert A. Taggart, Jr.

Corporate Financing: Too Much Debt?

Are U.S. corporations overburdened with debt? Since 1970, internal funds have been taking wider swings as percentages of total funds sources, as compared with the 1950s and 1960s. Furthermore, use of debt financing has been consistently higher since the mid-1960s than during previous periods throughout the century. And short-term debt has accounted for most of this rise.

After adjustment for inflation, however, the figures indicate that, since 1974, corporations have relied heavily on internal funds and cut their cost of debt financing to levels that are not high by historical standards. Despite fluctuations in internal funds and increased use of short-term debt, corporations do not appear to have significantly riskier capital structures than they've had in the past.

An examination of determinants of the composition of capital structure reveals that corporate reliance on debt financing increases as capital expenditures rise relative to available internal funds. Use of debt financing is limited, however, by investors' perceptions of the riskiness of the business environment and by relative supplies of federal government securities. Over long periods, furthermore, the tax system seems to affect the level of debt financing; corporate borrowing increases as personal income tax rates rise above corporate levels.

IN 1984, NEW DEBT accounted for 45 per cent of total sources of funds for U.S. nonfinancial corporations. Less than one-quarter of this new debt came from long-term bonds and mortgages; the rest represented short-term debt from a variety of sources. Moreover, 15 per cent of net funds sources went, not for investment in new plant and equipment, but for the repurchase of outstanding common stock.

Do such developments reflect increasing financial weakness of U.S. business? Many observers seem to think so. Their fears have been stimulated by such highly publicized trends as the levered buyout boom, the growth of "junk" bond financing, and the shrinkage of equity bases that often accompanies corporate restructuring. In addition, the current period is only the latest in a series of surges in corporate debt financing. Previous notable episodes occurred in 1968–69, 1973–74, and 1978–79.

Each of these surges gave rise to similar fears over corporations' financial condition. It has been argued that corporations' reliance on debt financing, particularly short-term debt, has made them increasingly vulnerable to economic shocks. This reliance on debt financing is in turn blamed on a combination of factors, including the tax system's favored treatment of debt over equity, reduced availability of internally generated funds during inflationary periods, and unrealistic assessments of business risk by executives, entrepreneurs and corporate raiders.

This article examines more closely these allegations of corporate financial weakness by comparing recent corporate financing patterns against long-term trends and by analyzing the link between these patterns and potential causal factors. The conclusion emerges that, in many

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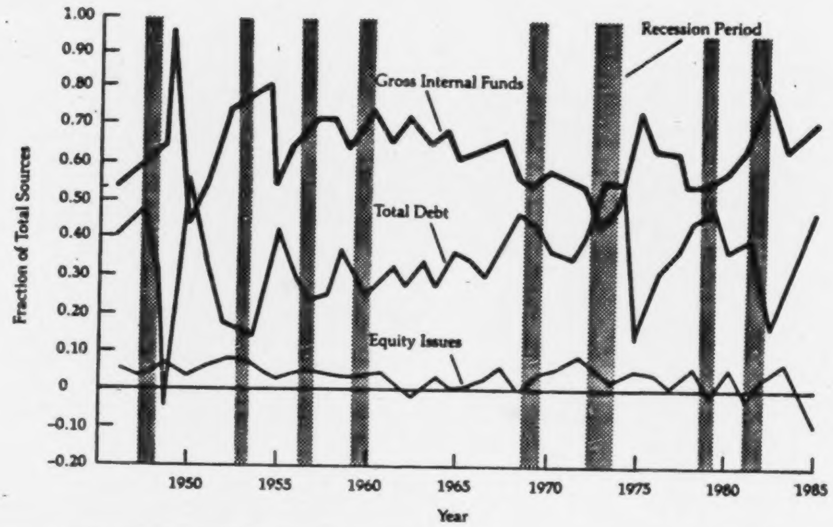
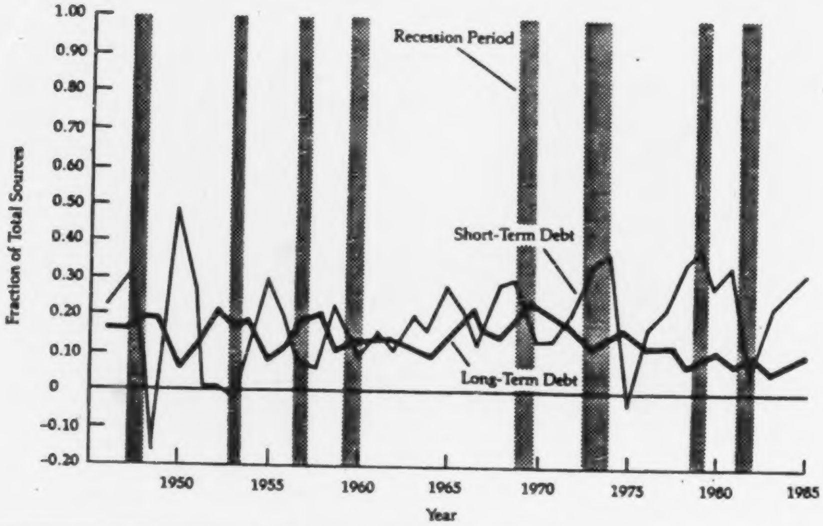
Figure A Fractions of Total Sources of Funds of U.S. Nonfinancial Corporations



Source: Board of Governors of the Federal Reserve System.

Figure B Short and Long-Term Debt as Fractions of Total Sources of Funds of U.S. Nonfinancial Corporations



Source: Board of Governors of the Federal Reserve System.

respects, the degree of financial weakening has been exaggerated. It must be conceded, nonetheless, that increased use of short-term debt and volatile capital market conditions have made corporate treasurers' lives more hectic.

The Historical Perspective

Figures A and B illustrate the yearly composition of funds sources for U.S. nonfinancial corporations during the 1946–84 period. Figure A shows the yearly flows of gross internal funds (retained earnings plus depreciation), total debt and new equity issues, all expressed as fractions of total sources of funds. Figure B shows the breakdown of total debt into long-term and short-term components.[1] The data are taken from the Federal Reserve's Flow of Funds Account.

The figures give a sense of the typical pattern in corporate financing over the course of the business cycle. The predominant feature of this pattern is the opposite movement of debt financing and the availability of internal funds. Toward the end of an expansion, and even into the early stages of a recession, the use of debt financing tends to increase sharply as capital spending and inventory investment outrun firms' generation of internal funds. Moreover, as Figure B makes clear, short-term debt accounts for the bulk of the increased debt financing during such periods. As the recession deepens, investment declines, and in the early stages of an expansion, internally generated funds typically come back faster than investment spending. At such times, firms use these internal funds, as well as long-term debt, to reduce their reliance on short-term liabilities.

It should be noted that the year 1984 represents a departure, in some respects, from this typical cyclical pattern. It is unusual for both internal funds and total debt to move in the same direction as proportions of total funds sources. In fact, 1984 was the first year in the entire postwar period in which the fractions of total funds sources accounted for by internal funds, long-term debt and short-term debt all moved in the same direction. The reason, as Figure A shows, was the unprecedented extent of stock repurchasing during 1984.

Clearly, 1984 was an unusual year. But is there any indication of a definite trend toward financial weakness? It does appear that the composition of corporate funds flows has become more volatile since the early 1970s. After a period of relative stability from the late 1950s to the late 1960s, internal funds and short-term debt have been taking wider swings as percentages of total funds sources, much as they did in the decade immediately following World War II. Perhaps this is a sign that corporate treasurers have had to worry more about maintaining flexibility in recent years. However, Figures A and B give little indication of any steady trends. To make a better assessment of whether such trends exist, it is necessary to smooth out some of the short-run fluctuations.

Secular Patterns

Table I presents the composition of corporate funds flows over selected longer periods. To give a long-run perspective, the Flow of Funds data, which cover only the postwar period, have been supplemented by Raymond W. Goldsmith's estimates for the 1900–45 period.[2]

Table I suggests that corporations' use of debt financing has been consistently higher since the mid-1960s than during previous periods throughout the century. Although it has been substantially reduced during the most recent decade, debt usage still remains at levels that appear high by historical standards. Issuance of long-term debt, however, has not been unusually high. Rather, it is short-term debt that has accounted for much of the rise in total debt. This increase in short-term debt has come from both credit market instruments and spontaneous sources, such as trade debt and tax liabilities.

On the equity side of financing activity, the availability of internal funds has fluctuated considerably from period to period, but no obvious trend is discernible. What does seem clear is that new stock issues declined substantially as a source of funds beginning in the 1940s, and they have remained relatively small ever since.

In a broad sense, the trends indicated in Table I would seem to justify the concerns of those who feel that corporate financial strength has eroded. Greater reliance on debt, especially short-term debt, and the apparent reluctance to issue equity would appear to have exposed the corporate sector to increased financial risk.

Before this conclusion is accepted, however, it should be recognized that inflation can cause figures such as those displayed in Table I to give a distorted picture of corporate financing activity. In particular, traditional measures of corpo-

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1. Footnotes appear at end of article.

Table I Composition of Funds Sources of U.S. Nonfinancial Corporations

Period	(1) Total Debt	(2) Long-Term Debt*	(3) Total Short-Term Liabilities	(4) Short-Term Credit Market Debt**	(5) New Stock Issues	(6) Gross Internal Funds
1901–12	0.31	0.23	0.08		0.14	0.55
1913–22	0.29	0.12	0.17		0.11	0.60
1923–29	0.26	0.22	0.04		0.19	0.55
1930–39	−0.33	−0.05	−0.29		0.19	1.14
1940–45	0.15	−0.05	0.20		0.05	0.80
1946–49	0.30	0.18	0.12	0.05	0.05	0.65
1950–54	0.31	0.14	0.17	0.05	0.06	0.63
1955–59	0.31	0.14	0.17	0.06	0.04	0.65
1960–64	0.30	0.13	0.16	0.07	0.02	0.69
1965–69	0.40	0.15	0.25	0.12	0.01	0.59
1970–74	0.47	0.18	0.29	0.14	0.05	0.48
1975–79	0.38	0.12	0.27	0.12	0.01	0.60
1980–84	0.36	0.10	0.26	0.15	−0.02	0.66

Sources: Board of Governors of the Federal Reserve System and R.W. Goldsmith, *Financial Intermediaries in the American Economy Since 1900.*

* Long-term debt consists of bonds and mortgages.

** Consists of bank loans, commercial paper, acceptances, finance company loans, and U.S. government loans.

rate internal funds do not take into account the annual decline in the real value of outstanding liabilities caused by inflation.

Inflation Effects

Capital market participants may or may not anticipate the extent to which inflation will occur. If they do not, lenders suffer an uncompensated real loss. This loss can properly be considered a gain to shareholders and therefore a part of firms' profits. Moreover, even if this profit component does not manifest itself as an immediate cash inflow, it does allow firms to increase their debt in nominal terms without any increases it its real burden.

If inflation is anticipated, however, lenders will protect themselves by demanding an inflation premium in the nominal interest rate. This premium does not represent additional real interest, but rather a repayment of real principal that compensates lenders for the decline in the real value of the debt that remains outstanding. As a debt repayment, this portion of interest payments should not be thought of as a current expense, or, it follows, a charge against profit. Similarly, an equal amount of new debt in a given period can be thought of as a rollover of that portion of the real principal that must be repaid, rather than as a net issuance of new debt.

Whether inflation is anticipated or not, then, one may make a case that conventional funds flow figures should be adjusted for inflation to give a more accurate picture of real financing activity. Accordingly, the figures reported in Table II have been adjusted by adding to each year's gross internal funds the decline during the year in the real value of debt outstanding at the beginning of that year.[3] This same amount has been subtracted from each year's net new

Table II Inflation-Adjusted Composition of Funds Sources

	Fractions of Total Sources of Funds			
	Gross Internal Funds		Total Debt	
Period	(1) Unadjusted	(2) Adjusted*	(1) Unadjusted	(2) Adjusted*
1901–12	0.55	0.56	0.31	0.30
1913–22	0.60	0.67	0.29	0.22
1923–29	0.55	0.55	0.26	0.26
1930–39	1.14	1.23	−0.33	−0.39
1940–45	0.80	0.87	0.15	0.08
1946–49	0.65	0.72	0.30	0.24
1950–54	0.63	0.66	0.31	0.29
1955–59	0.65	0.68	0.31	0.28
1960–64	0.69	0.70	0.30	0.29
1965–69	0.59	0.63	0.40	0.36
1970–74	0.48	0.57	0.47	0.38
1975–79	0.60	0.70	0.38	0.28
1980–84	0.66	0.77	0.36	0.25

Sources: Unadjusted data, see Table I; beginning-of-period liabilities, Board of Governors of the Federal Reserve System and R.W. Goldsmith, R.E. Lipsey and M. Mendelson, *Studies in the National Balance Sheet of the United States*, 2 Vols. (Princeton: Princeton University Press, 1963); price level changes are measured by implicit GNP inflator for 1901–48, *Historical Statistics of the United States*, and by index of total cost and profit for nonfinancial corporations for 1949–84, *Economic Report of the President*.

* Any inflation-induced decline in the real value of beginning-of-period debt is added to gross internal funds (and subtracted from total debt) for each period. Total beginning-of-period debt outstanding is multiplied by the percentage change in the price level during each period to compute changes in real value.

Table III Fraction of Available Internal Funds Paid Out as Dividends by U.S. Nonfinancial Corporations

Period	*Dividends as a Fraction of Dividends Plus Gross Internal Funds*	
	Unadjusted	*Adjusted*
1946–49	0.29	0.27
1950–54	0.28	0.27
1955–59	0.25	0.24
1960–64	0.24	0.24
1965–69	0.24	0.23
1970–74	0.24	0.21
1975–79	0.22	0.19
1980–84	0.22	0.19

Source: Board of Governors of the Federal Reserve System.

debt issues. The unadjusted figures from Table I are also shown for comparison.

As one would expect, these adjustments make a substantial difference for the three most recent periods. Nevertheless, one would still infer that corporations made use of debt financing to an unprecedented extent during the 1965–74 period. Since that time, however, reliance on internal funds has been heavy, while debt issuance has declined to levels that are not high by historical standards.[4] In short, the adjusted figures are much less indicative of a steady, long-run trend toward greater reliance on debt financing. They suggest instead that, following the debt surge of 1965–74, corporations have reverted to more normal financing proportions.

Both the adjusted and unadjusted data give a strong impression that corporations have made substantial efforts since 1974 to assume a more conservative financial posture. Table III gives further indication of such efforts: Corporations have paid out smaller proportions of available internal funds as dividends during the most recent two periods than during any other period in the postwar era. This has helped to reduce their reliance on debt financing.

The preceding analysis suggests that the fear of a steady erosion in corporate financial strength is probably exaggerated, despite the evidence of the postwar period. As Tables I and II indicate, the end of World War II is a potentially misleading reference point, because it followed a 15-year period of unusually low debt issuance.[5] When a longer-run view is taken, and especially when adjustments are made for the effects of inflation, any steady trend in debt financing is more difficult to detect.

Furthermore, charges of financial weakness often ignore the substantial effort corporations have made over the past decade to rebuild their balance sheets. At the very least, this effort belies the notion that corporate treasurers have become too cavalier in their attitudes toward financial risk. Nevertheless, there can be little doubt about the increased use of short-term debt. This development, in conjunction with the recent volatility of internal funds, has necessitated more frequent trips to the capital market and has forced corporate treasurers to devote more attention to financial flexibility.

Determinants of Financing Patterns

While it is of some use to know whether corporations' current reliance on debt financing is heavy by historical standards, it must also be conceded that the world today is not the same as it used to be. We could more confidently assess recent corporate financing patterns if we knew something about the forces that have shaped them.

To understand these forces, we must consider the nature of corporate financing decisions. When a corporation finances its assets, it offers investors a set of financial services. That is, it packages the return stream from those assets in the form of different types of securities, each of which offers investors some combination of risk, return and liquidity.

In deciding what kind of financing package it wants to sell, the corporation must consider the competition. Financial institutions, government entities and foreign businesses all raise funds in the capital markets, hence compete with one another in offering financial services. Corporations must therefore compare the costs they would incur by offering a given financing package with the costs their capital market competitors would incur. In addition, they must consider the relative supplies of different types of securities that other capital market participants are offering.

The Corporate Choice

In theory, the comparative costs of different sources of financing will lead corporations to use internal funds first, before turning to debt and, finally, stock issues. This is because dealings with the capital markets incur transaction costs, both explicit and implicit. Among the implicit costs is the potential undervaluation of securities, particularly equity.

Table IV Determinants of Corporate Debt Financing

Period	(1)[a] Debt Financing Proportion	(2)[b] Gross Internal Funds as a Fraction of Capital Expenditures	(3)[c] Debt Incentive Tax Ratio	(4)[d] Inflation Rate (% per year)	(5)[e] Perceived Risk (% per year)	(6)[f] Federal Borrowing as a Fraction of Total Borrowing
1901–12	0.31		0.00	2.1	10.12	0.03
1913–22	0.29		0.03	6.5	10.79	0.32
1923–29	0.26		0.11	0.1	12.59	−0.11
1930–39	−0.33		−0.12	−1.5	25.59	1.34
1940–45	0.15		0.23	6.4	11.46	0.96
1946–49	0.30	0.84	0.25	9.6	12.99	−1.12
1950–54	0.31	0.82	0.37	2.7	8.15	0.10
1955–59	0.31	0.90	0.40	2.7	9.14	0.04
1960–64	0.30	0.96	0.40	1.5	8.95	0.09
1965–69	0.40	0.81	0.40	3.9	8.96	0.07
1970–74	0.47	0.70	0.40	6.5	12.44	0.10
1975–79	0.38	0.91	0.39	8.4	10.35	0.20
1980–84	0.36	0.94	0.37	7.3	15.91	0.30

a. From Table I.
b. From Board of Governors of the Federal Reserve System.
c. Personal tax rate minus corporate tax rate all divided by one minus personal tax rate. Personal rate is measured as lowest statutory personal rate. Data taken from J.A. Pechman, *Federal Tax Policy*, 3d ed. (Washington, DC: Brookings Institution, 1977).
d. Measured as average annual percentage change in implicit GNP deflator. Data taken from *Historical Statistics of the United States* and *Economic Report of the President*.
e. Measured as average annual standard deviation of monthly changes in S&P 500 composite stock index. Data taken from Standard & Poor's *Trade and Securities Statistics*.
f. From Board of Governors of the Federal Reserve System.

Management has inside information about a firm's prospects and, other things equal, it will try to sell securities when prices are favorable. But if investors interpret the announcement of a new equity issue as a sign that management feels the stock price is high, they may discount the stock.[6] The corporation may avoid this problem by using internal funds. Internal financing also allows the firm to avoid the double taxation inherent in paying out taxable dividends and then raising new money from investors' after-tax savings. The availability of internal funds relative to capital expenditure needs should thus be an important determinant of firms' financing proportions.

Once firms turn to external financing, the costs and benefits of debt become important. Corporate debt enjoys a net tax advantage, for example, when corporate tax rates exceed marginal personal tax rates. The relative structure of corporate and personal tax rates should therefore influence corporations' reliance on debt financing. To the extent that corporate rates do exceed marginal personal rates, the tax advantage to debt should also rise with inflation. Under those circumstances, the benefit corporations derive from the tax deductibility of the inflation premium in interest rates exceeds the extra taxes debtholders must pay on the inflation premium.

Debt issues will be limited, however, by the potential costs of financial distress and by the costs of resolving conflicts of interest between shareholders and debtholders. Both these costs increase when the firm faces a riskier environment. Business risk should therefore be another major determinant of corporations' reliance on debt financing.

Finally, corporations in the aggregate may find that heavy supplies of substitute debt securities limit their own ability to issue debt on advantageous terms. In particular, the federal government is a major issuer of low-risk, taxable bonds, and its financing activities may exert an important influence on corporate financing patterns.

Some Evidence

Table IV compares past patterns in corporate financing with some rough measures of the determinants discussed above. Column 2 shows the ratio of (unadjusted) gross internal funds to capital expenditures. For the most part, this ratio is inversely related to the fraction of total funds sources accounted for by debt. This is consistent with the idea that corporations place greatest reliance on debt financing in periods when internal funds are low relative to capital expenditure needs. This pattern is particularly evident in the 1965–69 and 1970–74 periods.

Column 3 gives average "debt incentive tax ratios" for different periods. This ratio, defined as the difference between corporate and personal tax rates, divided by one minus the personal tax rate, measures the net tax advantage to corporate debt.[7] When the ratio takes on higher values, corporate debt issuance yields greater tax advantages, and *vice versa*.

The figures suggest that the net tax advantage to corporate debt rose rapidly after World War II, but that it has been relatively constant since the early 1950s. To the extent corporate debt usage has risen in the postwar period, the increased tax advantage may have been a contributing factor. However, tax factors do not appear capable of explaining the fluctuations in financing proportions that have taken place over shorter periods.

Column 4 shows average annual inflation rates for the different periods. High rates of inflation can increase the net tax advantage to corporate debt, and there is indeed some indication that rising inflation may be associated with increased debt financing. Note, however, that debt usage fell substantially during 1975–79—the same time average annual inflation rates reached their peak. The ability of inflation to explain short-term movements in total debt appears limited.

Inflation rates in recent years have been, not only high on average, but also very uncertain. Inflation may have had a greater impact on the split between long and short-term debt than on fluctuations in total debt. The more uncertain the inflation rate, the more investors will demand an uncertainty premium as well as an inflation premium in long-term interest rates. This may lead corporations to reduce the issuance of long-term debt.[8]

Column 5 presents a rough proxy for the perceived risk of the economic environment, hence for the implicit costs debt financing imposes on corporations. Specifically, risk is measured by the averages of yearly standard deviations of the percentage changes in month-to-month stock prices for each of the different periods.[9]

Although the relation is not perfect for each period, there does seem to be a tendency, as theory would suggest, for perceived risk and debt financing proportions to move in opposite directions. This is particularly apparent during the Depression years, when perceived risk rose tremendously. The unusual stability of the 1950s and '60s may have laid the groundwork for the increase in debt that occurred toward the end of that period and somewhat beyond. Of special interest to the interpretation of current developments are the recent movements in perceived risk. Although debt financing increased during 1970–74, together with perceived risk levels, the continuing higher level of risk, especially in 1980–84, may have contributed to the subsequent decline in debt proportions.

The last column in Table IV shows federal government borrowing by domestic nonfinancial sectors during the various periods. These figures are intended to measure the supply of substitutes against which corporate debt securities must compete in the capital market. Although, again, the relation does not hold for each period, there does seem to be a tendency for corporations to scale back their debt financing when the federal government assumes a more dominant role in the market. During the past 10 years, for example, the increase in federal borrowing may have contributed to the decrease in corporate debt financing.

To summarize, the degree of corporate debt financing rises and falls with the extent of capital expenditures relative to available internal funds. When capital spending needs are heavy relative to internal funds, corporations increase their reliance on debt financing, but the extent to which they are willing to do so is tempered by perceptions of business risk and by relative supplies of federal government securities. Over long periods, the tax system, in conjunction with inflation, also seems to exert some effect on corporate debt financing, but its short-run influence is more difficult to detect. The effect of inflation may stem more from inflation uncertainty rather than taxes, and its influence may be felt, not so much on the total extent of debt financing, but on the split between long and short-term debt.

Are Capital Structures Riskier?

Corporations' use of debt financing reached 45 per cent of total funds sources in 1984. Does this represent the continuation of an ominous trend? I believe the answer is no. Table I indicates that corporate debt financing has declined, on the whole, since 1974. When the data are adjusted for inflation, as in Table II, recent debt proportions do not appear unusually high by historical standards.

Certainly 1984 was unusual because of the large amount of stock repurchases. The rise of the levered buyout and other forms of corporate restructuring have evidently left their traces in the data. In view of the volatility of the composition of total funds sources over the past 15 years, however, it would be premature to conclude that these developments reflect any long-run trend toward riskier capital structures.

Have corporate executives shown an increased tendency to ignore business risk in their financing choices? In general, the evidence does not appear to support this claim. Recent increases in perceived risk have coincided with more conservative financing choices. Over the past 10 years, dividend payments have been restrained in order to conserve internal funds and reduce dependence on debt financing.

Is there nothing, then, to worry about? Before relaxing, you might take note of the sharp fluctuations in internal funds of late, as well as the increased use of short-term debt, which have placed a higher premium on corporate financial flexibility. As in the past, individual corporations will prove in the future to have made unfortunate financing choices today. But the corporate sector as a whole does not appear to be building a house of cards. To the extent that there is weakness in the U.S. financial system, the corporate sector is not the primary culprit. ■

Footnotes

1. Long-term debt is defined to include bonds and mortgages. Short-term debt includes bank loans, commercial paper, acceptances, finance company loans, U.S. government loans, profit taxes payable and trade debt. Because some unknown fraction of loans is actually long-term debt, this categorization is imprecise. However, even long-term loans in recent years have often had floating rates, hence have some of the characteristics of short-term debt.
2. See R. W. Goldsmith, *Financial Intermediaries in the American Economy since 1900* (Princeton: Princeton University Press, 1958). For a more complete discussion of these long-term financing trends, see R. A. Taggart, Jr., "Secular Patterns in the Financing of U.S. Corporations," in B. M. Friedman, ed. *Corporate Capital Structures in the United States* (Chicago: University of Chicago Press, 1985) and "Have U.S. Corporations Grown Financially Weak?" in B. M. Friedman, ed., *Financing Corporate Capital Formation* (Chicago: University of Chicago Press, 1986).
3. This adjustment procedure is discussed in G. M. Von Furstenberg and B. G. Malkiel, "Financial Analysis in an Inflationary Environment," *Journal of Finance*, May 1977, pp. 575–88. Further discussion of the relation between inflation, profitability and the real value of corporate debt can be found in F. Modigliani and R. A. Cohn, "Inflation, Rational Valuation and the Market," *Financial Analysts Journal*, March/April 1979, pp. 24–44.
4. Analysis of inflation-adjusted balance sheet debt ratios also yields the conclusion that current debt levels are not unusually high relative to historical experience. Estimates of the ratio of the market value of debt to both the market value of total capital and the replacement value of total assets are reported in Taggart, "Secular Patterns," *op. cit.*
5. Analysis of liquidity ratios leads to a similar conclusion. Corporate liquidity has declined substantially in the postwar period, but it was at an unusually high level following heavy corporate purchases of federal government debt during the war. See Taggart, "Have U.S. Corporations Grown Financially Weak?" *op. cit.*
6. For further discussion of this problem of asymmetric information, see S. C. Myers, "The Capital Structure Puzzle," *Journal of Finance*, July 1984, pp. 474–99.
7. There is, of course, a whole spectrum of personal tax rates. The one used in these calculations is the lowest statutory personal rate. The figures in Table IV thus approximate true movements in the tax advantage to corporate debt as long as the personal rates in the entire tax structure tend to move together over time.
8. Bradford Cornell elaborates on this argument in "The Future of Floating-Rate Bonds," in *Issues in Corporate Finance* (New York: Stern, Stewart, Putnam & Macklis, Ltd., 1983). For evidence that the uncertainty premium in long-term rates has been high in recent years, see Z. Bodie, A. Kane and R. McDonald, "Why Haven't Nominal Rates Declined?" *Financial Analysts Journal*, March/April 1984, pp. 16–27.
9. Because the degree of debt financing itself exerts a positive influence on stock price volatility, the independent effect of risk is difficult to disentangle. A better measure of business risk *per se* would be a standard deviation of returns to total corporate assets. Unfortunately, the data required for that measure are not available for the entire period encompassed by Table IV.

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DO TARGETS GAIN FROM DEFEATING TENDER OFFERS?

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and
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DO TARGETS GAIN FROM DEFEATING TENDER OFFERS?

Frank H. Easterbrook and Gregg A. Jarrell*

Do shareholders benefit from management decisions to resist tender offers? Professor Easterbrook and Mr. Jarrell think the evidence is unequivocal. They cite three recent studies of post-offer movements in the prices of target stocks which show that successful defensive tactics by management have deprived target shareholders of appreciation gains worth between fifteen and fifty-two percent of the value of target shares. They then introduce the results of their own more conventional study: had these gains been realized and reinvested in equity securities, shareholders would have fared considerably better during the past decade. The authors argue that a similar study by Kidder, Peabody & Co. reaches a seemingly contrary result because it erroneously compares the post-offer performances of these target stocks to the rate of inflation rather than to the performance of the equity market. The latter far outpaced inflation in recent years and thus, in the authors' view, provides a better measure of the true cost of defensive tactics to investors. This cost is enormous, the authors conclude, and warrants close judicial scrutiny, if not outright prohibition, of defensive tactics.

INTRODUCTION

One of the central questions in the debate about managers' responses to tender offers is whether defensive tactics are likely to make the targets' shareholders better off. If the defeat of an offer benefits these shareholders, then it follows that the decisions whether and how to defend should receive the same protection the business judgment rule accords other managerial decisions. If, on the other hand, the defeat of an offer is bad news for the target's shareholders, application of the business judgment rule is less defensible.

The business judgment rule is designed to protect managers from judicial reassessment of decisions that may or may not turn out well for the firm.[1] It reflects the fact that business decisions are risky and often in retrospect seem ill-advised. The business judgment rule gives managers the freedom to err, and thus it facilitates risk-taking. Perhaps more fundamentally, it reflects the fact that error-prone managers eventually are "selected out" by the process of competition among firms and among managers themselves.[2] Judges, on the other hand, are not chosen for their business acumen and are not fired or subject to reductions in salary if they err in assessing business situations. Judges also are accustomed to deciding cases on full records and may be too quick to blame managers who act—as they often should—in haste or on incomplete information. It is better to insulate all honest decisions from review than to expose managers and directors to review by judges and juries who do not face market pressures.

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[1] See, e.g., Joy v. North, 692 F.2d 880, 885-87 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983); Aronson v. Lewis, 473 A.2d 805, 812-15 (Del. 1984). See generally Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913 (1982); Veasey, Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions—An Analytical Framework for Litigation Strategy and Counselling Directors, 37 Bus. Law. 1247 (1982).

There has always been increased judicial scrutiny, though, of decisions by managers with conflicting interests.[3] Under the law of most states, these decisions are scrutinized for "fairness." This means that judges ask whether a decision of this type could have been reached by people acting at arms' length, with no self-interest. Judges are better at policing managers' loyalty than at policing their astuteness.

Tender offers create conflicts of loyalty in almost every case: to defend against the offer is to defend against a threat to one's job as well. Managers' promises of fidelity to shareholders' interests are less likely to be honored when the stakes are so large for the managers themselves. Even when the evidence of conflicting interests is weak, some courts have been willing to restrict the scope of managers' discretion. For example, some courts have closely scrutinized directors' efforts to dismiss derivative litigation pending against fellow directors.[4] When the evidence of conflict is convincing—when certain kinds of self-interested decisions always or almost always turn out poorly for the shareholders—the rationale of the business judgment rule is seriously undermined.

Defensive responses to tender offers could be classified as "ordinary" business decisions and protected by the business judgment rule. They could be classified as "self-interested" decisions and subjected to review for "fairness." Or they could be classified as outside the scope of managers' implicit authority and banned altogether. Each of these positions has its partisans.

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[2] See Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence (collecting and discussing the evidence about how markets influence and discipline managers) (on file at New York University Law Review).

[3] Where a director has a personal interest in fending off a threat to corporate policy and control, courts do not presume that the director has acted in the corporation's interest. See, e.g., Cheff v. Mathes, 199 A.2d 548 (Del. 1964); Bennett v. Propp, 187 A.2d 405 (Del. 1962); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967).

[4] Compare Joy v. North, 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983) and Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) with Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). See generally Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 Stan. L. Rev. 927, 940-46 (1983).

Recent judicial decisions, supported by much commentary, apply the ordinary business judgment rule.[5] The cases are not very strong, though. Each of the three most important was decided by a vote of 2-1, and state courts have yet to speak. In contrast, some scholars have argued for outright prohibition of defensive tactics.[6] (There is a further dispute about whether attempts to find "white knights" and run auctions, in addition to attempts to remain "independent," should be within such a ban.[7] For current purposes we examine only outright defenses, by which firms seek to defeat all offers.) The SEC's Advisory Committee on Tender Offers took a middle position, proposing to permit some defensive tactics, to regulate others by requiring special votes of shareholders, and to ban some under defined circumstances.[8] Some courts, too, have used the Williams Act to prohibit certain defensive tactics.[9] Such decisions appear to have support from the Supreme Court's statement, in the course of invalidating state anti-takeover laws, that defensive tactics are damaging to shareholders.[10]

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[5] See Panter v. Marshall Field & Co., 646 F.2d 271, 293-99 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 380-84 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981); see also Herzel, Schmidt & Davis, Why Corporate Directors Have a Right to Resist Tender Offers, 3 Corp. L. Rev. 107 (1980); Lipton, Takeover Bids in the Target's Boardroom: An Update After One Year, 36 Bus. Law. 1017 (1981) [hereinafter Lipton Update]; Lipton, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel, 55 N.Y.U. L. Rev. 1231 (1980); Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979); Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 Colum. L. Rev. 249 (1983); Note, Tender Offer Defensive Tactics and the Business Judgment Rule, 58 N.Y.U. L. Rev. 621 (1983).

[6] See Baron, Tender Offers and Management Resistance, 38 J. Fin. Econ. 331, 342 (1983); Bebchuk, The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028, 1029, 1054 (1982); Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1198 (1981); Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 Bus. Law. 1733, 1733 (1981); Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 878-79 (1981); see also SEC Advisory Committee on Tender Offers, Report of Recommendations 99-104, 109-20 (1983) (separate statement of Easterbrook and Jarrell arguing for a prohibition of defensive tactics as a second-best solution to the inequalities created by the Williams Act and responding to arguments favoring unrestrained defense) [hereinafter Advisory Committee Report].

One important assumption in these anti-defense arguments is that the Williams Act or some equivalent set of rules hinders the tactics of bidders and gives the targets' managers the opportunity to mount effective defenses. If bidders were free to select their tactics, we and many of the other authors listed above would take a quite different position on judicial review of defensive tactics.

[7] Compare Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982) (opposing auctions as well as outright defense) with Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension, 35 Stan. L. Rev. 23 (1982) (opposing defense but not auctions) and Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L. Rev. 51 (1982) (same, but on different arguments).

Many paths lie ahead. The recommendations of the SEC's Advisory Committee must be considered by Congress and the SEC, as well as by the state legislatures and the courts.[11] The American Law Institute's Corporate Governance Project will address tender offers and defensive tactics. Although some portions of the ALI's project have been circulated in draft form, the part on these subjects has not been written. Proposed revisions of the ABA's Model Business Corporations Act are circulating for comment, and the proposals contain recommendations that bear on these subjects. Congress, the SEC, the ALI, and the ABA all need to know whether defensive tactics are likely to make the targets' shareholders better off. To shed light on this issue, we present some evidence from financial economics and then consider the major piece of contradictory evidence. We show that, when viewed in the proper light, the evidence is not contradictory at all. Both sources of evidence demonstrate that targets' shareholders lose when managers defeat tender offers. Because what is good for investors in this respect is good for the economy as a whole, the loss is felt widely.[12]

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[8] Advisory Committee Report, supra note 6, at 13 (considering regulations of auctions), 18 (Rec. 9.b recommends that the business judgment rule govern takeover contests), 34 (Rec. 33 endorses business judgment rule, subject to caveat in n.31 and Rec. 34 concerning state anti-takeover laws), 36 (Rec. 35 opposes high barriers to change of control in articles and bylaws), 36-37 (Rec. 36 calls for supermajority voting on some anti-takeover provisions), 38-39 (Rec. 37 calls for advisory votes on some defensive provisions), 40-41 (Rec. 38.a would ban Golden Parachutes adopted after commencement of an offer), 42 (Rec. 39.b would prohibit self-tender with expiration date in advance of bidder's date), 43 (Rec. 40 would ban PAC-MAN defense as a response to a bid for 100% of target's stock), 44 (Rec. 41 would limit issuance of stock during offer to 15%, unless shareholders' approval obtained).

[9] See Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981) (lock-up options granted by target to competing tender offeror manipulative); Data Probe Acquisition Corp. v. Datatab, Inc., 568 F. Supp. 1538 (S.D.N.Y.) (same), rev'd, 722 F.2d 1 (2d Cir. 1983). Contra Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 760 (2d Cir.) (sale of option and treasury stock by target to competing tender offeror not manipulative), cert. denied, 104 S. Ct. 550 (1983); see generally Note, Target Defensive Tactics as Manipulative Under Section 14(e), 84 Colum. L. Rev. 228 (1984).

[10] Edgar v. MITE Corp., 457 U.S. 624, 643 (1982) (defenses hinder the "reallocation of economic resources to their highest valued use" and reduce "the incentive the tender offer mechanism provides incumbent management to perform well").

[11] The SEC has endorsed some of the Advisory Committee's proposals, rejected some, and stated that it needs more time to examine others. See Statement of John S.R. Shad, Chairman of the SEC, to the House Subcommittee on Telecommunications, Consumer Protection and Finance [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,511 (Mar. 28, 1984). The Commission appears quite skeptical about defensive tactics, proposing (among other things) to prohibit the issuance of lock-up options amounting to more than 5% of a firm's stock without approval by shareholders. See Tender Offer Reform Act of 1984, H.R. 5693, 98th Cong., 2d Sess. (1984). It has expressed doubt, though, that anti-defense rules should come from federal rather than state law.

I

THE EVIDENCE ABOUT DEFEATED OFFERS

A. *Direct Price Comparisons*

There are two kinds of evidence about the consequences of defensive tactics. Those who support defensive tactics have argued that corporations that fend off tender offers often do quite well. Martin Lipton describes the fate of McGraw-Hill, which defeated an offer for $40 only to see the price of its stock rise above that level within two years, as an example.[13] According to Lipton, other targets also prosper after defeating offers. This line of argument draws substantial support from a study by Kidder, Peabody & Co.

The Kidder study[14] analyzes 38 defeated hostile tender offers between 1974 and 1982 in which the target remained independent for at least one year. The study used four different methods to assess the effect of defeating a tender offer. Depending on the method used, the study purports to show that the shareholders of between 45% and 97% of all targets did better, as a result of the defeat of the offer, than they would have done if the offer had succeeded. At the low end of Kidder's range is a comparison of the price on February 28, 1983, discounted at the rate of inflation, versus the offer price. The discounted February 28 price exceeded the offer in 45% of all cases. The high end compares the highest price a stock attained after the offer with the original offer; 97% of the "highs" exceed the original offer.

The inference many draw from the Kidder study is that defense often is beneficial to targets' shareholders. If this inference is correct, then it seems to follow that managers' decisions should be fully protected by the business judgment rule.[15] On the other hand, if the Kidder study is misleading, quite a different inference is in order.

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[12] Some people have said that tender offers may be socially bad, though privately profitable, because they "use up credit" or otherwise distort markets. This kind of criticism reflects ignorance of how credit markets work, as the SEC's Advisory Committee unanimously recognized. See Advisory Committee Report, supra note 6, at 13-14, 72-74.

[13] See Lipton Update, supra note 5, at 1026.

[14] The Kidder study was submitted to and considered by the SEC's Advisory Committee on Tender Offers.

B. Evidence from Financial Economics

There is a body of evidence that suggests that the Kidder study is not the right way to look at things. This evidence, developed through the use of the powerful tools of financial economics, focuses on the movements in the price of stock at the time an offer is made and at the time it is defeated. The methodology works roughly as follows.[16] First examine the movements of a firm's stock in the recent past to determine its "beta"—the extent to which its movements are a function of the market's or some industry group's movements. For example, if on average a stock's price rises 2% when the market (or its industry group) rises 1%, and falls 2% when the market falls 1%, the stock has a beta of 2. Then use the stock's beta, together with knowledge of what other stocks did near the time of a tender offer, to determine any "abnormal" movements in the price of the stock. If the stock has a beta of 2, and the market rises 2% on a given day, we expect the stock to rise by 4% on average. If it rises 6%, then it has done better than expected, and the 2% difference is an unexpected gain to investors. If, instead, it rises only 1%, it has done 3% worse than expected; we infer that something bad happened to the firm in relation to the market. The next step in the process is to examine the abnormal gains and losses of all targets near the time tender offers are made and withdrawn. Do they gain, relative to expectations, when offers are made? Do they gain, relative to expectations, when offers are defeated and withdrawn? The final step is to separate targets that defeated offers into two groups. The first contains targets that remained "independent." The second contains targets that were acquired by another bidder, whether this occurred with the target's consent or over its objection.

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[15] Only "seems" to follow because what is beneficial to shareholders when an offer is on the table is not necessarily what shareholders would have selected in advance. If a strategy that drives up the price also decreases the likelihood of an offer, it may or may not help shareholders. See the exchange of views in note 7 supra.

[16] For more detailed statements of the method and its applications, see, e.g., Brown & Warner, Measuring Security Price Performance, 8 J. Fin. Econ. 205 (1980); Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. Law. 1 (1982); Schwert, Using Financial Data to Measure Effects of Regulations, 24 J.L. & Econ. 121 (1981).

Three studies of this character have been performed in an effort to determine the effects of defensive tactics.[17] All three studies show that investors in firms that defeated offers and remained independent for some time lost significantly when compared with the value of the offer and the value of successful transactions. They disclose identical patterns: the price of a target's stock rises dramatically, approximately 30% relative to the rest of the market, when an offer is announced. If the first offer is defeated and a later offer succeeds, the price rises a little more. If the offer is defeated and no other takes its place, the entire gain is lost. At the cost of omitting some other important data and qualifications, we summarize the findings as follows:

Study	Appreciation on Announcement of Bid	Effect of Defeat*	Effect of Sale in Auction*	Cost of Defeat
Asquith	ca.15%	+ 1.0%	n.a.**	ca. − 15%***
Bradley, Desai & Kim	35.5%	+ 3.43%	55.73%	− 52.3%
Jarrell	30.0%	+ 9.0%	38.00%	− 29.0%

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* Relative to pre-offer price. The Bradley, Desai & Kim data show effects one year after the initial bid; the Jarrell data show effects 100 trading days after the bid; the Asquith data show effects 60 trading days after the bid.

** Asquith's method of reporting data does not permit us to extract this number.

*** To compute the cost of defeat, we simply used the appreciation on the announcement of the bid as an estimate of the opportunity cost of defeating the bid.

The table shows, to use the Bradley study as an example, that when a bid was announced stock prices appreciated by about 35%. When a bid was defeated, the price fell back to approximately the same level as before the bid (an increase of 3.4% relative to pre-bid price); when it succeeded, the average auction premium was about 56%. Thus the loss the shareholders suffered because of defeat, the available premium less the post-defeat value, was about 52% of the total value of the stock. The effect in no-auction cases is the first column (35%) less the second, or a loss of about 32%. All studies demonstrate very large differences between how shareholders fared when their firms defeated offers and how they would have fared had the offers been successful. (The other studies apply slightly different methods of analysis to different samples of offers over different periods of time. Thus the difference in the results is not surprising.)

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[17] See Asquith, Merger Bids, Uncertainty, and Stockholder Returns, 11 J. Fin. Econ. 51 (1983); Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers: Information or Synergy?, 11 J. Fin. Econ. 183 (1983); Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge? (forthcoming in J.L. & Econ.) (draft on file at New York University Law Review). For a comprehensive summary of many related studies, see Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983).

We find these data exceptionally powerful. All three studies show that the defeat of an offer means very large losses for investors. Other people are reluctant, however, to draw the obvious inference. In presenting these findings to the SEC's Advisory Committee on Tender Offers, and in other forums, we have encountered a number of responses worthy of brief discussion. Before we start, though, it is important to realize that the methods generating these numbers are not controversial within the economics profession. There is no debate about this subject in the way monetarists, Keynesians, and supply-siders debate employment and inflation. The method of analyzing market returns is almost universally accepted as valid, subject only to questions about the sources of data and the exact structure of the equations.[18]

1. Profits Versus Prices

The data we report are based on stock market movements at the time of the events, not accounting numbers or "real" profits. Thus, it may be said, they do not show either social gains or "reliable" gains to investors. As it turns out, accounting profit studies also do not measure real social gains,[19] but this is not terribly important here. For investors, what matters is that they can cash out immediately at a gain and invest elsewhere.[20] For society, what matters is that the higher prices accompanying acquisitions reflect estimates of future gains. Prices are reasonably good proxies for these gains, at least when large numbers of firms are involved, because stock prices are based on estimates of future real profits and dividends. Higher equity prices also attract new capital into the market and increase the rate of savings. (For what it is worth, the available evidence on the profitability of tender offers suggests that they result in no unusual profits or losses. In other words, an investment of $X in a target appears to be about as profitable for a bidder as an investment of $X in other assets, such as new plants. This is what one would expect to see if managers of bidders are behaving rationally.)

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[18] There is, for example, debate about whether the "arbitrage pricing model" offers slightly better estimates than the model used in the studies we described; about the strength of the inferences; and about the comprehensiveness of the samples of events on which the conclusions are based. These differences, even taken together, affect only the magnitude rather than the existence or direction of the effects described.

[19] See Fisher & McGowan, On the Misuse of Accounting Rates of Return to Infer Monopoly Profits, 73 Am. Econ. Rev. 82, 97 (1983); Liebowitz, What Do Census Price-Cost Margins Measure?, 25 J.L. & Econ. 231, 245-46 (1982).

[20] For purposes of this analysis, we disregard other considerations that might affect a shareholder's decision to cash out: the tax consequences and transaction costs of selling stock, the costs of locating a suitable alternative investment, and the availability of a market for the stock or a satisfactory appraisal remedy.

A related argument is that the finance studies emphasize the short-term results at the expense of the longer term. Managers, it may be said, know the longer term better than the market. This criticism misses the mark for two reasons. First, it is not accurate to say that the studies of abnormal returns are flawed because they look only at "instantaneous" price changes and not changes over a longer period. The studies do both. The studies summarized in the table above offer an "instantaneous" result in the first column. They tell you what happens to all of the target's stock when a bid is made for part or all. (The reason the abnormal gain is less than the average premium of 50-70% is that most bids are for less than all stock, and some bids fail. The "all stock" appreciation reflects the fact that not all investors will receive gains in all cases.)

The results in columns two to four are *delayed* results. Column three shows offers that we know in retrospect were successful. The investors in targets in these successful offer cases receive appreciation higher than the gains that we observe on the day the offer is made. Column two shows targets that we know in retrospect defeated all offers for an extended period. The investors in *these* targets show either losses, two years later, relative to the pre-bid price (Bradley, Desai & Kim) or losses, four months later, relative to the initial price (Jarrell). The losses relative to successful bids, shown in column four, are staggeringly large.

The second reason why this criticism is unavailing is simple: many careful studies have shown that the price of stock on any given day *is* the best estimate of the price of stock in the future. We return to this below.

2. *Unusual Events*

The studies of tender offers treat gains and losses to investors as averages, while individual cases may diverge from the pattern. This is true, but the implication is obscure. When legislatures or courts design rules of law, they must act on the basis of averages rather than outlying or unusual events. Society gains from inventions and the construction of new plants, even though many inventions and new plants are wastes. The fact that in 5% of all cases the investors of targets that stay independent may gain is not a very good excuse for defense, as a rule, if the other 95% lose and if—as we think likely—any rule of law designed to protect the 5% also affects the other 95% to their detriment.[21]

3. *Imperfect and Incomplete Evidence*

The studies we have mentioned inevitably have flaws. They are based on incomplete samples of tender offers and may be affected by the quirks of particular offers. Thus one cannot say the data are "conclusive." Yet this is an unrealistic demand for economic data. Suppose we were to study business decisions about whether to engage in searching for new ways to grow corn, or about introducing new products, or building new plants. The evidence about the profitability of these highly beneficial things is much less powerful than the evidence about tender offers. To believe, as some apparently do, that society does not lose much if managers defeat offers because the data do not conclusively prove the damage of such actions is to believe that society also would not lose if Congress systematically set about to discourage new ideas, new products, and new plants.

4. *Inefficient Markets*

Many people just cannot believe that stock markets are efficient, and they reject all studies and inferences that in their view are based on assumptions concerning efficiency. Louis Lowenstein is a good example. He argues that many targets are "well managed," so tender offers are unlikely to be value-increasing, and that markets cannot be efficient because stock prices jump around "too much" in relation to "intrinsic values" for the market to be pricing them well.[22] Thus, Lowenstein argues, the stock market data are misleading and independence is a beneficial goal.

There is an enormous body of evidence showing that stock markets are efficient both in the sense that the price of stock on any given day is the best estimate of its future price and in the sense that movements in the price of stock are "unbiased" (meaning that changes neither overshoot nor undershoot the price in the longer run).[23] Those who challenge the efficiency of the stock markets usually do not take issue with these findings. They maintain, rather, that the markets are inefficient in the sense that "the price is not right." That is, they observe (accurately) that often a stock is over- or under-priced in relation to its "true" (future) value.

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[21] Investors prefer whatever arrangement maximizes total gains. This is obvious if each investor holds a diversified portfolio, but it is also true of undiversified investors. See Makowski, Competition and Unanimity Revisited, 73 Am. Econ. Rev. 329 (1983); cf. Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 711-14 (1982). Because shares are tradeable and are repriced in response to legal rules, no rule can succeed in transferring income from one class of investors to another.

[22] See Lowenstein, supra note 5, at 289-94.

Efficiency in this "right price" sense is not, however, an assumption of the method used in the studies we reported above. Evaluation of the gains and losses from offers depends only on the assumption that the degree of pricing accuracy does not change rapidly. So long as the price a year from now is about as likely as today's price to be "right," inferences based on large numbers of cases will be reliable. "Wrong" prices will offset one another, and any substantial changes in average prices, or average responses, will enable us to determine the costs and benefits of defensive strategies.[24]

C. *The Kidder, Peabody Study Once More*

A substantial number of skeptics remain. We have heard over and over the question: "If these studies are right, then what about the Kidder, Peabody study?" The implication is that the Kidder study is countervailing data, and that the dispute calls for continued application of the business judgment rule.

The Kidder study examines the consequences of defenses by comparing the bidder's offer against an "adjusted" price of the target's stock at some later time. The adjustment takes into account any inflation during the time between the offer and later price. If the bid was made in 1980, and the later price was observed in 1982, Kidder deflated the 1982 price to "1980 dollars" using the Consumer Price Index (CPI). It then compared this deflated price with the offer. If the deflated price exceeded the offer, Kidder concluded that the defense was beneficial for the target's investors. Using this definition, Kidder concluded that investors gained between 45% and 97% of the time (depending on the subsequent date chosen).

We have checked the Kidder sample, data, and computations. We found no serious errors. Yet we are unshaken in our belief that successful defenses are calamities for the target's investors. This is so because the Kidder study simply is not inconsistent with the work examining abnormal returns. The Kidder study is a textbook example of how, if you approach data with the wrong question, you will get a misleading answer.

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[23] See R. Brealey, An Introduction to Risk and Return from Common Stocks 3-20 (2d ed. 1983) (summarizing many of the pertinent studies); see also J. Cragg & B. Malkiel, Expectations and the Structure of Share Prices (1982) (impressive demonstration that market professionals do not "beat the market," as they should if there were unexploited opportunities for those with the best information to outguess today's price).

[24] See Advisory Committee Report, supra note 6, at 107-09, 116-18 (separate statement of Easterbrook and Jarrell discussing the role of "efficiency" in creating and interpreting similar data).

To understand why Kidder's question is wrong, consider a simple example. Suppose you own stock in Widgets Inc., which on December 1, 1980, was trading for $20. The next day Raider Corp. bids $30 for 100% of the stock. If successful, Raider would pay cash on January 1, 1981. Widgets Inc. beats back the offer, and you are left with shares that on January 1 trade for $20. Two years later, your stock trades for $34 (including the value of reinvested dividends). The 70% gain over $20 looks pretty good. Are you better off? Kidder would say "yes." The $34 is higher than the $30 bid, and if you adjust the $34 to "1981 dollars" you still have more than $30. Kidder would view anything over $33.94 as a gain.[25]

You would disagree with Kidder, though, if you thought you could do better than inflation with your investments. Suppose you had $30 in hand on January 1, 1981, to invest however you wanted. If you had bought a market basket of stocks, you would have had more than $34 by January 1, 1983, because during that time a value-weighted index of New York Stock Exchange firms, including reinvested dividends, rose 14.64%, exceeding inflation.[26] Knowing how Widget Inc. does against how you would have done with the cash is the sort of comparison you would care about. The stock versus the CPI does not tell you much unless by accident the market just tracks inflation. As it turns out, though, for most of the period covered by the Kidder study, especially 1980 and 1982-83, the stock market gain was much greater than inflation. Thus the Kidder study is seriously biased because it ignores what happened to other equity investments.

The extraordinary rise in the stock market over 1980-83 places the defeated bids in a different perspective when compared with the subsequent price of the target. Kidder labels defeats as beneficial just because the whole market rose. Similarly, if the market had fallen, Kidder's method would have greatly overstated the losses incurred by investors in targets, because the price of the targets would have gone down with the market while the imputed value of the bids would have risen with inflation. None of this is a very satisfactory way to assess consequences for investors.

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[25] The Consumer Price Index increased 8.9% in 1981 and 3.9% in 1982. Thus $30 × 1.089 × 1.039 = $33.94.

[26] This figure and all the others in our study come from the tape of daily stock prices maintained by the Center for Research in Securities Prices at the University of Chicago.

It is possible to make an accurate comparison only by taking into account how the market as a whole behaves. We tried to do this. To see how investors really fared, we did a new study, using all of the firms in the Kidder sample that were traded on the New York or American Stock Exchanges, according to the following method. This method uses none of the assumptions and practices that are challenged by those who do not accept the findings of modern financial economics.

We assumed that the targets "accepted" the bidders' offers and that the shareholders invested the proceeds in a diversified portfolio of all equities traded on the New York and American Stock Exchanges. (Of course particular investors would have purchased some less complete sample, but the market as a whole indicates how investors as a whole would have done.) Then we examined this investment one, two, three, etc., months after the offer to see how the portfolio was performing compared with the targets' actual stocks (given the real defeats of the offers). If the portfolio was doing better than the target, we viewed the defeat of the offer as bad news for the targets' shareholders.[27]

We constructed an index that compares the results of the actual investment (given the defeat of the offer) with the hypothetical investment following the hypothetical success of the offer. If the two are equal at any time after the offer's defeat, the index is 1.00. If the actual stock is 10% higher than the basket of equities obtained after success, then the index is 1.10. If, however, the shareholder would have done better with the defeated offer, the index is below 1.00. If, for example, the target's stock does 10% worse than the investor would have expected to achieve in the market, the index is 0.90.

The results of this study are striking. A month after the offers, the targets' stock was trading for about 10% less than the "invested proceeds." Two months later, we see a further 10% decline. Three months (60 trading days) after the offers, 27 of the 31 firms in our sample have index values less than one. Five months (100 trading days) after the offer, 28 of 31 still have indices less than one; the average index is .83.

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[27] This method actually understates, by a substantial amount, the gains the investors would demand to make them indifferent between the success of the offers and their defeats. There has been a generally rising market in equities. The stocks of individual targets are riskier investments than the stocks of the market as a whole. In order to be indifferent between targets' stocks and the market, investors demand compensation for the risk, and these individual stocks actually rise faster than the market (while other firms, such as AT&T and big utilities, rise more slowly). In treating targets' stocks as if they were as safe as the whole market, we give a substantial advantage to the thesis that defense is beneficial. In other words, the method described in the text erroneously assumes that targets' stocks have beta coefficients of one.

Over the course of two years after the offer, the targets as a group fluctuate at a 10% to 20% loss relative to the "invested proceeds." There they sit. The targets never recover. The invested proceeds always do better. So it turns out, if you ask the right question, that the single apparently contrary study is not so contrary after all.

We reproduce our study in an appendix in both tabular[28] and graph form.[29] In the table the company is listed in column one. The other columns give the date relative to the announcement of the offer. Date -20 is 20 trading days (a month) before the offer, and so on. In each column there are two index numbers for each company. The bottom number is the index we have described above. The top number gives the current price of the stock on the listed trading date relative to a basket of equities that could have been purchased by selling the stock 40 days before the offer. This top index will equal 1.00 whenever the offer (followed by defeat) made the shareholders no worse off than they would have been if no offer had ever been made. The final listing in the table, called the "Equal Weighted Portfolio," is the average index of all 31 target stocks. The index number relative to the offer (the lower number in the table) is less than one for the portfolio as a whole on all subsequent dates and less than one for the vast majority of all targets on each subsequent date.

In the first graph the horizontal axis is the number of days after the announcement of the initial bids, and the vertical axis is the relation between the actual price of all target stocks taken as an average (subtracting market movements) and their price at the time of the offer. It is the equivalent of the bottom index in the table. This ratio drops steadily from 1.00 at the time of the offer to about 0.85 after it becomes clear that the offer has been defeated. The second graph is the equivalent of the table's top index. It shows a rise from the average pre-offer price to more than 1.40 at the time of the offer. This is a benchmark; it shows what the investor could have had by taking the offer. The subsequent decline illustrates how the gains slowly ebb away over time as the likelihood that the offer will succeed (or that another offer will be made) goes down.

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[28] See Appendix A at 294-97 infra.

[29] See Appendix B at 298-99 infra.

The table shows that *some* targets' stocks did better than the investor would have done by taking the offer and investing in the market as a whole. For example, 60 trading days (three months) after the offer, four of the 31 firms had indices exceeding one. (We use the second index number from the table because it shows value relative to the offer.) Does this demonstrate that some managers cleverly outguessed the market and saved their investors from losing money?

To test whether the presence of some gains shows astuteness or just random variance, we asked the following question: "If every manager who resisted a tender offer *expected* the firm to lose 10% of its value, what number of firms nonetheless would appreciate just by chance?" In other words, how likely is it that the pattern of gains and losses we observe would exist even if every target expected its index to be 0.90? This is a simple test, for which statistical methods are well developed.[30] The test shows that the probability is about 98.84% that chance alone would have produced four "winners" even if all defeats of tender offers were expected to be bad news for the targets' investors.[31] Indeed, this method of looking at the data predicts that managers *expected* to lose about 20% relative to the market by defeating the offers. Given such an expectation, and given the volatility of the targets' stocks, four targets could have had indices exceeding 1.00, just by chance.[32] That is exactly what happened.

CONCLUSION

It does not matter how one looks at defeated tender offers. Any method that takes into account the movement of the stock market shows that managers who resist tender offers to the point of defeating them do a grave disservice to their investors. The size of the loss is 52% of value by some methods, such as comparing success with defeat in the Bradley, Desai & Kim study reported above; it is 30% of value using the method in Jarrell's study reported in the same table. If we use the most conservative assumptions, such as assuming that targets' stocks are as "safe" as the whole market (which we did in reassessing the Kidder study), we can shrink the size of the loss to 15% or so. But the loss just will not go away. A 15% loss in tender offers of the sort examined here represents an enormous loss in shareholders' equity.

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[30] This statistical approach assumes that prices fluctuate around some "true" value and that the size of the average daily fluctuation is known but the direction of the fluctuation is selected randomly. It is possible to find out how far, and with what probability, a future price would diverge from this "true" value after *n* days of such fluctuations. A large number of trials with a given "true" value and average daily fluctuation will yield a probability distribution, the mean and median of which will be the "true" value, with prices extending higher and lower. By specifying the expected fluctuation and the "true" value, we can therefore find the likelihood that on a given day the actual price in the market will be a given amount higher than the "true" value.

[31] We omit the description of the method, but it is a standard combinatorial problem. It helps to think of the process as one that fills an urn with balls, some of which are colored to reflect the probability that by chance a given firm with a history of fluctuating prices will have an index value exceeding one after 57 days of fluctuations. For the sample of firms here, the chance for each firm is 2,840 in 10,000. If you draw 31 balls from an urn containing 10,000 balls, and 2,840 of the balls are black, what is the chance of getting at least four black balls? We will not go into the math behind the answer, which turns out to be 98.84%.

[32] If you use the method employed in note 31 supra and select an index of 0.80 as the expected or true value, you find that the chance of any one target's index exceeding 1.00 is 12.7%. The best expectation is that you will draw about four black balls in 31 tries from a large urn, if 12.7% of the balls are black.

These findings have substantial implications for the treatment of the business judgment defense. If, as the data show, managers who resist tender offers to the point of defeating them almost always harm the shareholders, there is little reason for judges to accord deference to these decisions and good reason to treat them as self-protective measures. The inference we draw is fortified by still another kind of evidence. Managers who try to defend are overpaid (relative to the firm's profits and the pay of managers elsewhere) and in danger of replacement.[33] Their efforts to keep their salaries and positions are understandable but not excusable. It is past time to prohibit defense or subject it to the most exacting scrutiny to protect the interests of investors.

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[33] Walkling & Long, Agency Theory, Managerial Welfare, and Takeover Bid Resistance, 15 Rand. J. Econ. 54 (1984).

APPENDICES

APPENDIX A

Abnormal Performance Indices of Targets that Defeated Tender Offers, for Thirty-One Targets and for Equal-Weighted Portfolio

	Trading Days Relative to Tender Offer Announcement					
Company	−30	−20	−10	−5	0	5
Amax Inc.	1.0425	1.0402	1.0221	0.9746	1.4614	1.4324
	—	—	—	—	—	1.0644
Brunswick Corp.	0.9517	0.9668	0.9938	1.0067	1.4003	1.5109
	—	—	—	—	—	0.9623
Canal Randolph	1.0382	1.0667	1.1103	1.1277	1.7166	1.4927
Corp.	—	—	—	—	—	1.0808
Chicago Rivet &	0.9571	0.9159	0.9174	0.9674	1.1786	1.2166
Mach. Co.	—	—	—	—	—	1.0249
Dictaphone Corp.	1.1064	1.0946	1.3692	1.4271	1.5679	2.1437
	—	—	—	—	—	1.0577
Foremost-	0.9005	0.9228	0.9715	0.9899	1.0423	1.0583
McKesson Inc.	—	—	—	—	—	0.9806
Gerber Prods. Co.	1.0309	1.0885	1.2042	1.2156	1.2132	1.4304
	—	—	—	—	—	1.0561
Grumman Corp.	0.9349	1.0086	0.9960	0.9745	1.6528	1.5219
	—	—	—	—	—	0.9758
Gulf Res. &	1.0147	1.2369	1.2814	1.2770	1.5840	1.4969
Chem. Corp.	—	—	—	—	—	1.0088
Heinicke Instrs.	1.0325	1.0018	0.9803	0.9785	1.0478	0.9995
	—	—	—	—	—	0.9902
Harnischfeger	0.9746	0.8989	0.9508	0.9658	1.6127	1.6045
Corp.	—	—	—	—	—	0.9623
Harsco Corp.	1.0750	0.9928	1.0452	1.0393	1.2069	1.2413
	—	—	—	—	—	1.0052
Inspiration	0.9519	0.8234	0.7852	0.8224	1.0834	1.0056
Cons. Copper Co.	—	—	—	—	—	0.9659
Kennecott Corp.	0.9551	0.9627	0.8225	1.0276	1.0340	1.0170
	—	—	—	—	—	0.9396
Levitz	0.9828	0.9366	0.9522	0.9477	1.1064	1.1006
Furniture Corp.	—	—	—	—	—	0.9904
Ludlow Corp.	1.1128	1.0794	1.1719	1.3223	1.6757	1.5560
	—	—	—	—	—	0.9540

10	20	40	60	100	160	240
1.3817	1.5693	1.2026	1.3559	1.4480	1.2218	0.9242
1.0267	1.1661	0.8936	1.0075	1.0760	0.9079	0.6868
1.4441	1.4476	0.9899	1.0034	1.2483	1.3128	1.1683
0.9197	0.9220	0.6305	0.6391	0.7950	0.8361	0.7441
1.4532	1.3294	1.3346	1.4094	1.1701	1.0781	1.1606
1.0522	0.9625	0.9663	1.0205	0.8472	0.7806	0.8403
1.2758	1.2466	0.8616	0.8492	0.8008	0.7931	0.6937
1.0748	1.0502	0.7258	0.7154	0.6747	0.6682	0.5844
1.3907	1.4551	1.3952	1.5153	1.4266	0.9661	0.9664
0.6861	0.7179	0.6884	0.7476	0.7038	0.4766	0.4768
0.9833	1.0095	0.9391	0.9384	0.8514	0.8843	0.9715
0.9110	0.9354	0.8701	0.8695	0.7888	0.8194	0.9002
1.3915	1.3537	1.2242	1.2551	1.3051	1.1476	1.2368
1.0274	0.9995	0.9038	0.9266	0.9636	0.8473	0.9132
1.5503	1.3304	1.0820	1.0616	1.1399	1.2127	1.6522
0.9940	0.8338	0.6937	0.6807	0.7309	0.7776	1.0593
1.4913	1.1773	1.0101	0.8566	0.9970	1.0004	1.7253
1.0050	1.7934	0.6807	0.5773	0.6719	0.6742	0.4888
1.0160	1.0391	1.1309	1.0475	0.8196	0.6089	0.5942
1.0065	1.0294	1.1203	1.0377	0.8120	0.0319	0.5886
1.6573	1.5211	1.6140	1.6390	1.4196	0.9140	0.9574
0.9940	0.9123	0.9680	0.9830	0.8514	0.5482	0.5742
1.2206	1.2290	1.1703	1.2018	1.2906	1.3006	1.2795
0.9884	0.9952	0.9477	0.9731	1.0451	1.0532	1.0361
0.9642	0.9776	0.9689	0.8229	0.6932	0.5785	0.5542
0.9261	0.9389	0.9306	0.7903	0.6658	0.5557	0.5323
1.0461	1.0673	0.8870	0.8524	0.7856	0.9426	0.8470
0.9667	0.9863	0.8197	0.7877	0.7260	0.8711	0.7827
1.1755	1.1082	1.0442	1.0484	1.8056	1.9052	0.9004
1.0578	0.9972	0.9396	0.9434	0.7249	0.8145	0.8103
1.6013	1.4568	1.4268	1.1556	1.2393	1.1587	1.0575
0.9818	0.8932	0.8748	0.7085	0.7598	0.7104	0.6483

Abnormal Performance Indices of Targets that Defeated Tender Offers, for Thirty-One Targets and for Equal-Weighted Portfolio (Continued)

	TRADING DAYS RELATIVE TO TENDER OFFER ANNOUNCEMENT					
Company	**−30**	**−20**	**−10**	**−5**	**0**	**5**
Mead Corp.	0.9012	0.9305	0.9812	0.9550	1.3598	1.2755
	—	—	—	—	—	0.9824
Marshall Field &	1.0325	1.0041	1.1377	1.1223	1.5948	1.4774
Co. Del.	—	—	—	—	—	1.0084
McGraw Hill Inc.	1.0871	1.1398	1.1085	1.1146	1.4070	1.4518
	—	—	—	—	—	0.9628
Pargas Inc.	1.0094	0.9790	0.9586	1.1229	1.3580	1.3060
	—	—	—	—	—	0.9868
Rowan Cos. Inc.	1.0121	1.1258	1.2289	1.1678	1.7422	1.6786
	—	—	—	—	—	0.9872
Sabine Corp.	1.0322	0.9989	1.0083	1.0958	1.2019	1.2310
	—	—	—	—	—	1.0083
Sterndent Mng. Co.	0.3254	0.8457	0.9136	0.8591	0.8364	1.2652
	—	—	—	—	—	0.9906
Sunshine Mfg. Co.	0.9547	1.0086	1.1421	1.1501	1.3560	1.3202
	—	—	—	—	—	0.0691
Simplicity	1.0512	1.0411	1.0635	1.0534	1.1231	1.0081
Pattern Inc.	—	—	—	—	—	0.9270
Texas Int'l Co.	1.1186	1.4456	1.5582	1.6929	1.73[illegible]	1.7268
	—	—	—	—	—	1.0194
TeleCom Corp.	1.2820	1.2167	1.1121	1.0985	1.4156	1.3826
	—	—	—	—	—	0.9718
Unitek Corp.	0.9046	0.9412	0.9676	0.8863	1.2[illegible]81	1.2120
	—	—	—	—	—	0.9926
Universal Leaf	0.9817	0.9852	0.9612	1.0093	1.0252	1.1917
Tob. Inc.	—	—	—	—	—	1.0466
Viacom Int'l Co.	1.0364	1.1587	1.0402	1.0323	1.4132	1.3001
	—	—	—	—	—	0.8800
Woolworth, F.W. Co.	0.9885	1.0840	1.1006	1.1184	1.4682	1.3686
	—	—	—	—	—	0.9605
Equal Weighted	1.0125	1.0281	1.0593	1.0820	1.4052	1.4254
Portfolio	—	—	—	—	—	0.9906

10	20	40	60	100	160	240
1.3145	1.2597	1.2887	1.2650	1.0685	1.1964	1.0657
1.0125	0.9702	0.9926	0.9743	0.8229	0.9215	0.8209
1.5844	1.5254	1.6721	1.0993	1.1574	1.0184	0.8326
1.0815	1.0412	1.1413	0.7503	0.7900	0.6951	0.5683
1.4746	1.3197	1.0842	1.1130	1.0702	1.1025	1.1646
0.9779	0.8752	0.7190	0.7381	0.7098	0.7312	0.7724
1.4112	1.2054	1.1508	1.1528	1.1083	1.1968	1.4246
1.0663	0.9108	0.8695	0.8711	0.8375	0.9043	1.0764
1.6742	1.6117	1.4230	1.3770	1.2652	1.1869	1.4311
0.9846	0.9479	0.8369	0.8098	0.7441	0.6981	0.8417
1.2143	1.2832	1.2094	1.0871	1.2041	1.1950	1.2557
0.9946	1.0510	0.9905	0.8904	0.9863	0.9788	1.0285
1.5074	1.4579	1.2042	1.0443	1.1166	0.9247	1.1009
1.1802	1.1415	0.9428	0.8176	0.8742	0.7240	0.8619
1.2871	1.2537	1.2433	1.2091	1.0935	1.0030	1.0419
0.9448	0.9203	0.9126	0.8875	0.8026	0.7362	0.7648
0.9924	1.0061	1.0700	1.0610	0.9065	0.9416	0.6617
0.9126	0.9252	0.9839	0.9757	0.8336	0.8659	0.6084
1.6338	1.5452	1.5953	1.5069	1.3299	1.5771	1.9577
0.9646	0.9123	0.9418	0.8896	0.7851	0.9311	1.1558
1.3948	1.3102	1.0788	1.0188	1.2654	0.8932	0.6686
0.9804	0.9209	0.7583	0.7161	0.8894	0.6278	0.4700
1.2462	1.1625	1.0584	1.0725	1.0800	1.1575	1.2177
1.0206	0.9521	0.8668	0.8783	0.8845	0.9479	0.9973
1.1761	1.1873	1.1149	1.1772	1.3530	1.2479	1.3325
1.0329	1.0427	1.9798	1.0388	1.1882	1.0959	1.1702
1.3248	1.5259	1.5695	1.3401	1.4481	1.9004	2.1770
0.8967	1.0329	1.0623	0.9071	0.9802	1.2864	1.4736
1.3927	1.3270	1.2453	1.2104	1.2369	1.2094	1.0445
0.9775	0.9314	0.8740	0.8495	0.8681	0.8488	0.7331
1.4275	1.3913	1.2951	1.2521	1.2400	1.2044	1.2074
0.9920	0.9668	0.9000	0.8701	0.8617	0.8370	0.8391

Note: Index 1 is the top index, which measures abnormal performance of target's stock relative to stock price 40 trading days before the announcement of the tender offer. Index 2 is the bottom index, which measures abnormal performance of target's stock relative to stock price three days after the announcement of the tender offer.

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RESTRUCTURING 87

Is America Helping Herself?

Corporate Restructuring and Global Competitiveness

• *John D. Paulus and Robert S. Gay*

The last few weeks of 1986 could well go down as a watershed period in the competitive struggle facing corporate America. General Motors, IBM, and AT&T — all giants without peer in U.S. industry — introduced significant restructuring programs that were aimed at restoring their preeminence as low cost producers. This spate of announcements represents the frankest admission yet of America's increasingly acknowledged international competitiveness problem, one that is symbolized dramatically by the soaring trade deficit. The flip side of this shortfall, the dependence on foreign capital to finance the trade gap, implies that Americans presently are living beyond their means. Such a trend cannot continue and thus the United States is finally facing up to the fact that it either will have to accept a lower standard of living or will need to become more competitive by raising worker productivity.

The American competitiveness problem has its roots in the inflation of the 'Seventies. During that decade productivity growth slipped badly, as ever-rising product prices protected inefficient production practices. Moreover, many workers represented by strong unions were able to extract wage gains which failed to reflect the slump in output per hour. In some industries — such as steel, autos, and trucking — wage premiums, or the excess of wages in a given industry over the national average, vaulted from the 30% to 40% range at the beginning of the 'Seventies to over 70% by the end of the decade.

This competitiveness problem became increasingly obvious as import penetration rose substantially in the 'Seventies, even before the U.S. dollar skyrocketed during the first half of the 'Eighties. For example, the share of U.S. expenditures on manufactured goods devoted to imports roughly doubled from 1968 to 1981, rising from 4.3% to 8.4%. For some industries, the increase in penetration during this time frame was truly spectacular; for apparel this percentage rose from 4.2% to 13.7%, for leather and leather products from 8.9% to 24.7%, for steel from 12.2% to 21.8%, for machine tools from 14.6% to 29.4%, and for motor vehicles and parts from 5.7% to 21.7%.

The sharp rise in the dollar from 1981 to 1985 worsened the competitive disadvantage of U.S. firms and contributed to the burgeoning trade deficit. Thus, with high costs, increased import penetration, and a strong dollar, corporate America would have to undertake a massive adjustment program to repair the damage done to the nation's competitive position.

COPING WITH COMPETITIVE DISADVANTAGE THROUGH RESTRUCTURING

The U.S. has reacted to its competitive inadequacies largely, though not exclusively, by seeking to redeploy assets in configurations that are aimed at enhancing productivity.[1] The popular term for this process is "corporate restructuring," which refers to such practices as closing of inefficient plants and modernizing of others, shedding of businesses that require specialized management skills, the granting of wage concessions, and the paring of "fat" from bloated corporate bureaucracies. Even deregulation, as applied to the trucking and airlines industries, for example, represents a form of restructuring, which, in turn, intensifies competition since new firms entering the industry operate at costs lower than those of existing companies.

Playing an integral role in the overall restructuring process is financial restructuring — mergers, acquisitions, and leveraged buyouts — which facilitates transfers of ownership and, ultimately, changes in management and work practices. Moreover, the mere threat of such a change in ownership may induce senior managers to reshape their corporations before outside forces enter the picture. At the very least, financial restructuring is a natural by-product, and perhaps an important catalyst, in corporate America's struggle to regain its once preeminent competitive stature.

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[1] America also has adopted some protectionist measures in order to shield certain struggling industries, but thus far these have been limited in scope.

A precise measure of the extent of corporate restructuring is impossible. But the dollar value of merger and acquisition activity is certainly related to the degree of restructuring in the broader sense. Using this measure, it is possible to gauge the relationship between the amount of restructuring in a given industry and subsequent gains in productivity and cost control. Such analysis can help to answer the question: "What is corporate restructuring doing to the American economy?" Ultimately it also sheds light on the more important question, "Is America helping herself to improve competitiveness?"

FINANCIAL RESTRUCTURING AND PRODUCTIVITY IN MANUFACTURING

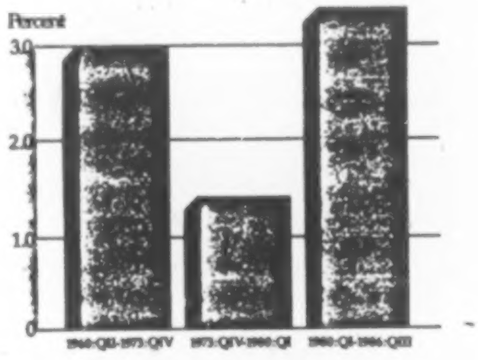
Merger and acquisition activity began to take off in 1981, not by coincidence a year when the realities of heightened import penetration began to hit home. The next surge began in 1984 and has continued ever since. Over the past six years a fairly stable proportion of M&A activity — between 50% and 65% — has occurred in manufacturing and mining, sectors that represent the bulk of our goods-producing infrastructure that has become increasingly vulnerable to foreign competition. In 1985, these two sectors accounted for about 25% of U.S. output.

What is particularly intriguing is the fact that there has been an impressive improvement in productivity in the manufacturing and mining sectors during the time period when M&A has accelerated. As Figure 1 illustrates, from the first quarter of 1980 to the present, productivity in the manufacturing sector has grown at an average annual rate of 3.3%, up significantly from an average of only 1.4% for 1973 to 1980 period, and higher even than the 3.0% average growth recorded from 1960 to 1973.

Such a performance in output per hour in the 1980 to 1986 period is especially impressive since production expanded slowly on average over the period — at an average rate of only 2.3% annually. And it is widely conceded that high rates of productivity growth are much easier to achieve during periods of rapid growth when resources are more intensively utilized.

Moreover, during the 1980 to 1986 period, productivity in manufacturing, where restruc-

Figure 1
MANUFACTURING PRODUCTIVITY



Restructuring has helped to revive productivity growth in manufacturing after the dismal performance of the '70s.

turing was especially intense, appears to have greatly outperformed that of the rest of the economy where restructuring was less intense. As shown in Table 1, from 1948 to 1980 productivity growth in the industrial sector was about equal to that recorded for the nonfarm economy overall.[2] However, with restructuring intensifying after 1980, the performance of productivity in manufacturing has been far superior to that of the nonfarm economy as a whole.

Table 1
MANUFACTURING AND NONFARM BUSINESS PRODUCTIVITY

	1948: I to 1980: I	1980: I to 1986: III
Manufacturing	2.7	3.3
Nonfarm business	2.1	1.1

Source: Bureau of Labor Statistics.

A widening disparity has emerged between productivity growth in manufacturing and in the rest of the non-farm economy.

RESTRUCTURING AND PRODUCTIVITY AT THE INDUSTRY LEVEL

If restructuring can, in fact, be linked to the solid improvement of productivity in manufacturing, those industries in which asset redeployment has been most intense should also show the largest gains in output per hour. To address this question, we must first develop a gauge of restructuring. To facilitate our analysis, we have constructed what we call a restructuring intensity measure (RIM), the ratio of the share of M&A activity accounted for by each industry relative to that same industry's share of U.S. output. For example, if an industry accounted for, say, 10% of financial restructuring in a given year, but only for 5% of GNP, then its RIM would be 2.0. Thus, if the RIM is greater than one — that is, if financial restructuring is proportionately greater than output for a given industry — that segment of the economy has been intensively restructured. On the other hand, if the RIM is equal to one, restructuring intensity would be average, and if less than one, below average.

Table 2 reveals some stunning productivity success stories for industries that have undergone extensive restructuring. Shown are productivity records for industry groupings that have RIM ratios greater than one and have experienced substantial improvements in productivity growth in the 'Eighties, compared with the 'Seventies. For example, after eking out very little, if any, productivity gains during the 'Seventies, industries such as metal mining, coal mining, sawmills, hydraulic cement, steel, primary copper, copper rolling, motor vehicles, tires, and railroad transportation have achieved impressive productivity gains of 5% or more annually during the 'Eighties.[3] These dramatic turnarounds are all the more remarkable because many of these industries have not enjoyed strong increases in output; indeed, virtually all the rise in production is due to higher productivity.[4] Obviously, the firms involved have taken concerted actions to bolster their competitive position.

To be sure, not all industries have participated in the revival of productivity growth. For example, a number of nondurable goods industries have experienced smaller gains this decade than during the 'Seventies. Indeed, average productivity performance in the

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[2] In deference to statistical rigor, we have not computed an estimate of nonmanufacturing productivity from the available statistics in Table 1, because those series are based on output estimates which are not strictly consistent with each other.

[3] Two restructuring ratios in Table 2 that are less than 1.0 (rubber and miscellaneous plastic products and stone, clay, and glass) actually understate the extent of financial restructuring in the subindustries listed (tires and hydraulic cement) because it was there that merger and acquisition activity was concentrated. A complete listing of industries is presented in the Appendix.

[4] In this regard, the productivity performance in metal mining has been nothing short of phenomenal. Output per hour soared 8% to 10% annually between 1980 and 1985 even though production actually fell 7% per year on average. Likewise, output declined in many primary metals industries, yet productivity performance was excellent.

Table 2

PRODUCTIVITY TRENDS AND RESTRUCTURING IN SELECTED INDUSTRIES

	Restructuring Intensity Measure (RIM) 1980 to 1985	Average Annual Productivity Change		
		1973 to 1980	1980 to 1985	Change in Trend
Metal Mining	16.4			
Iron Ore		1.4%	8.1%	6.7%
Copper		1.1	9.9	8.7
Coal Mining	2.5	−1.6	6.5	8.1
Total Manufacturing	1.6	1.2	3.7	2.5
Lumber and Wood Products	2.2			
Sawmills and Planing Mills		0.6	5.4	4.9
Stone, Clay, and Glass	0.9			
Hydraulic Cement		−1.9	8.7	10.6
Primary Metals	1.5			
Steel		−0.5	6.1	6.6
Gray Iron Foundries		−0.6	3.8	4.3
Primary Copper, Lead, &Zinc		1.3	13.0	11.7
Primary Aluminum		0.1	3.7	3.6
Copper Rolling and Drawing		0.1	6.5	6.4
Fabricated Metals	1.4			
Automotive Stampings		1.0	4.6*	3.6
Machinery, Except Electrical	1.0			
Refrigeration and Heating Equipment		−1.3	2.1*	3.4
Electric and Electronic Equipment	1.6			
Radio and Television Sets		4.2	14.4*	10.2
Transportation Equipment	1.6			
Motor Vehicles and Parts		0.8	6.2	5.3
Textile Mill Products	1.2			
Nonwool Yarn Mills		2.3	5.3	3.0
Rubber and Misc. Plastic Products	0.8			
Tires and Inner Tubes		1.1	7.3	6.3
Railroad Transportation	3.1	1.5	8.6	7.1

* Productivity statistics are available through 1984.

Source: Bureau of Labor Statistics, U.S. Department of Commerce, Morgan Stanley & Co.

nondurable goods sector (2.8% annually) has not been as high as that for durable goods (4.4%), perhaps because nondurables producers, in general, have not felt an urgency to revamp production techniques in the face of intense foreign competition. And industries such as mass transit, electric utilities and some retailers have suffered outright declines in productivity in recent years, and have not undertaken much restructuring either.

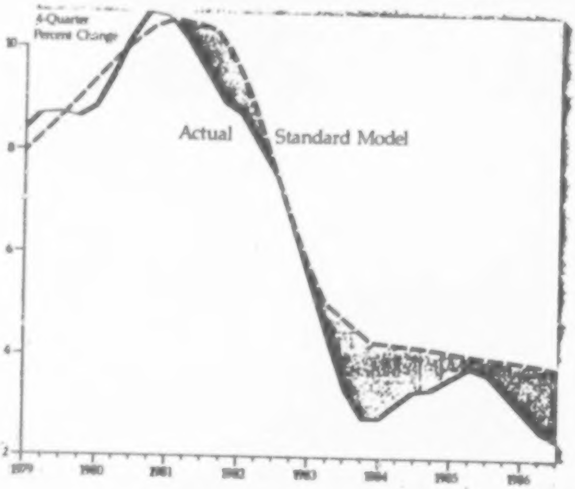
Also notably absent from Table 2 are producers of capital equipment and some other high-tech items. The mediocre productivity performance in high-tech industries, despite considerable financial restructuring, is particularly worrisome. Until the early 'Eighties, the U.S. had enjoyed substantial trade surpluses in capital goods, reflecting comparative advantages in productive efficiency. Over the past few years, however, those surpluses have dwindled steadily to the point where we actually were running a trade deficit in capital equipment in the second quarter of 1986. While the overvalued dollar undoubtedly contributed to that decline, lackluster productivity performance of late also has permitted foreign competitors to close the gap in productive efficiency, which has made the task of regaining lost market shares more difficult.

STRUCTURAL CHANGE AND WAGE CONCESSIONS

U.S. industry also has made progress in trimming wage costs. As recently as mid-1981,

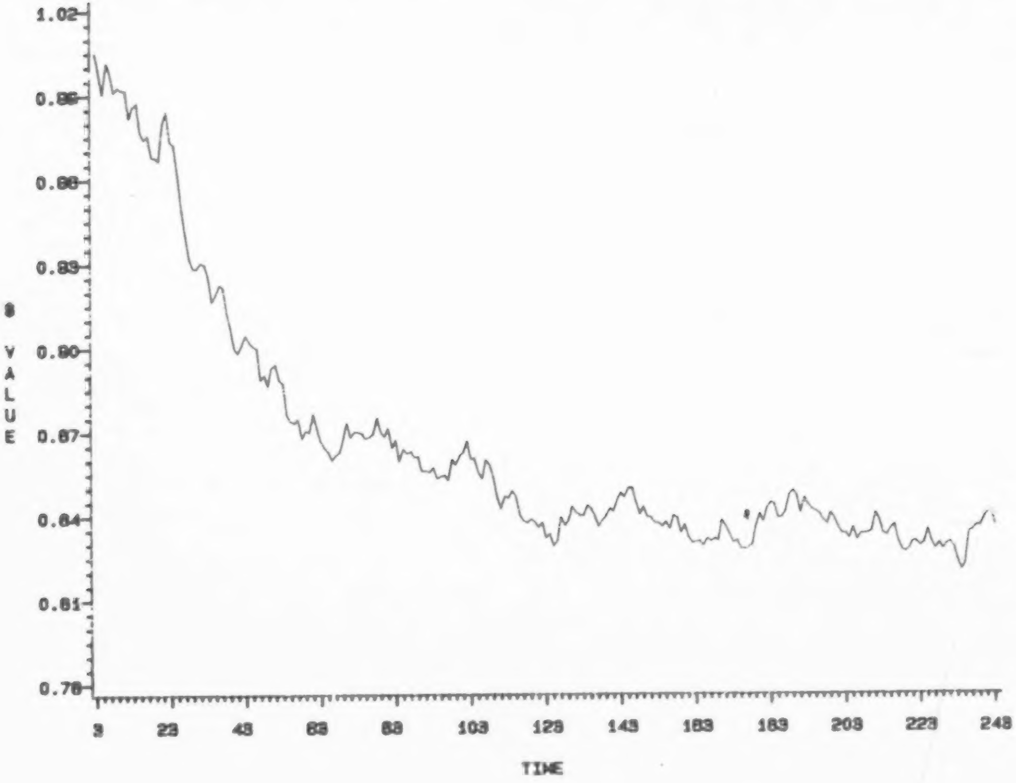
Figure 2

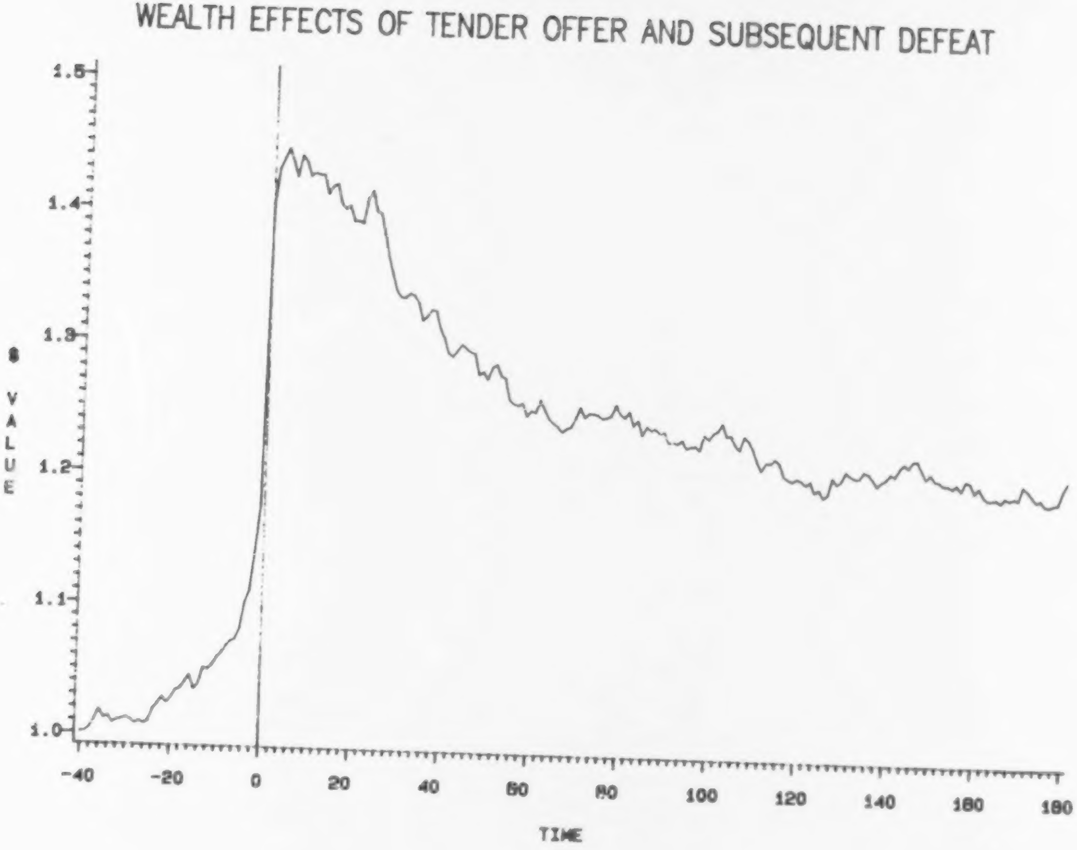
ACTUAL AND PREDICTED WAGE CHANGES IN MANUFACTURING



Intensified competition has caused an exceptionally sharp reduction in wage increases.

WEALTH EFFECTS OF DEFEATING TENDER OFFER




WEALTH EFFECTS OF TENDER OFFER AND SUBSEQUENT DEFEAT
$ VALUE
1.5
1.4
1.3
1.2
1.1
1.0
-40
-20
0
20
40
60
80
100
120
140
160
180
TIME

wage increases in manufacturing industries averaged 10%. By 1983, however, wage rate adjustments had plummeted on balance to about 3% and have remained around that subdued rate ever since. As shown in Figure 2, this deceleration in wages was far greater than would have been expected based on historical relationships with macroeconomic conditions alone — mainly unemployment and inflation. Indeed, from 1983 through 1986, wage inflation in manufacturing averaged an estimated one percentage point per year less than normal. A good deal of the abnormally abrupt easing in wages can be attributed to competitive pressures arising from extensive restructuring.

The unusually pronounced slowdown in wage inflation was concentrated in heavily unionized industries and coincided with an unprecedented outbreak of so-called "concessionary" settlements, which froze or even cut base wage rates over the life of multiyear agreements. In each of the past five years, with the sole exception of 1984, more than half of union workers reaching new labor contracts in manufacturing have accepted initial wage reductions or freezes. Likewise, wage "concessions" were pervasive in mining, construction, and the deregulated transportation industries — airlines and trucking.

Almost invariably, wage cuts and freezes have occurred at firms whose competitive positions have deteriorated badly during the 'Seventies, either because wage premiums had risen substantially or because productivity performance had been dreadful. Moreover, by the 'Eighties "new" competition from foreign producers or domestic nonunion firms emerged.[5] Burdened with high costs and besieged by aggressive new competitors, many unionized firms were faced with a case of "do or die." In that light, the

Table 3

RATIO OF HOURLY EARNINGS IN SELECTED INDUSTRIES TO AVERAGE FOR PRIVATE NONFARM PRODUCTION WORKERS

Industry	1969	1973	1977	1981	1983	1985	First Half 1986
Trucking[1] (Master Freight Agreement)	1.31	1.59	1.63	1.73	1.63	1.53	1.50
Autos[2]	1.39	1.45	1.57	1.70	1.70	1.73	1.72
Steel[3]	1.35	1.42	1.64	1.81	1.67	1.63	1.67
Rubber[4]	1.38	1.33	1.38	1.53	1.54	1.54	1.56
Mining	1.18	1.20	1.32	1.38	1.41	1.40	1.42
Machinery[5]	1.16	1.21	1.27	1.32	1.28	1.27	1.28
Primary Metals	1.25	1.28	1.41	1.49	1.42	1.36	1.37

[1] Straight-time hourly wage rates are specified in Master Freight Agreements
[2] SIC 3711, motor vehicles and car bodies
[3] SIC 3312, blast furnaces and steel mills
[4] SIC 301, tires and inner tubes
[5] SIC 353, constructuion

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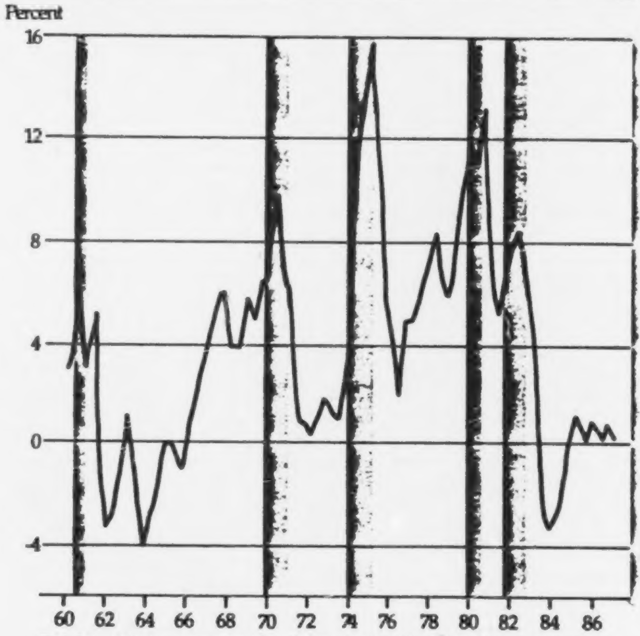
[5] For an elaboration of these points, see Robert S. Gay, "Union Settlements and Aggregate Wage Behavior in the 1980's," *Federal Reserve Bulletin*, December 1984, pp 843-856.

expense-cutting efforts of the past five years are an encouraging sign that U.S. industry is chipping away current cost disadvantages.

Table 3 gives some sense of how far we have come. In all of the industries listed, management and unions have negotiated concessionary settlements during the 'Eighties. As a result, wage premiums — as measured by the ratio of wage rates in the industry to the average for all nonfarm workers — have at least stabilized since 1981 and in some cases have declined significantly. Nonetheless, as of 1986 all the ratios were still well above those that prevailed in the late 'Sixties. The combination of continued high premiums and the fact that the new low-cost competitors will not simply "go away" implies that pressures to reduce premiums further will persist for quite some time.

The bottom line is that the restructuring of U.S. industry during the 'Eighties has helped considerably to keep labor cost pressures at a minimum. As shown in Figure 3, over the past

Figure 3
GROWTH OF UNIT LABOR COSTS IN MANUFACTURING



Shaded areas indicate recessionary periods as designated by the National Bureau of Economic Research.

Improvements in productivity growth and smaller wage increases have broken the upward spiral in cost pressures.

five years labor costs per unit of output in manufacturing literally have been flat. More significantly, the usual pattern of increasing cost pressures over the course of economic expansions has been decisively broken during the current business cycle. As we enter the fifth year of this upturn, unit labor costs in manufacturing still are showing no signs of a pickup.

CONCLUSION

Corporate restructuring does appear to be enhancing the competitiveness of our nation's producers. In the process, substantial value has been created through altered ownership, redeployment of assets, and the overhauling of management. In a sense, this conclusion should not be surprising since the stock ~~market has~~ consistently awarded premium values to target companies involved in financial restructuring. And it should help to discredit those who worry that stock market advances of recent years have been based upon "speculative excesses" associated with "takeover fever." Takeovers, after all, do not represent a mere shuffling of paper as ownership changes, but rather reflect fundamental alterations in the deployment of assets which, as we have documented, have induced major improvements in productivity.

Much remains to be done before America's competitiveness problem disappears. The trade deficit, the most succinct measure of the severity of the difficulty and its principal symptom, is likely to shrink only marginally in 1987. Moreover, as noted earlier and as shown in the Appendix, many industries have made little progress as yet in improving productive efficiency.

The U.S. has three choices in confronting her competitiveness problem. First, corporate restructuring can continue, raising productivity and lowering costs in the process. This constructive solution could eventually narrow the trade deficit, while enabling the nation to protect and enhance its high standard of living.

Second, we could undertake monetary and fiscal policies designed to lower the foreign exchange value of the dollar significantly. However, this alternative would make the nation poorer, since for a given endowment of human and fixed capital, the lower dollar merely raises the cost of foreign goods and services.

Third, the U.S. could erect meaningful protectionist barriers, turning the U.S. into the world's premiere high-cost producer. In this event, even fewer foreigners would want to buy our high-priced products and services than currently. In the end, even without foreign retaliation, which most likely would follow, protectionism would end up impoverishing the nation just as lowering the dollar would.

We believe the U.S. will continue to restructure its economic base until America again becomes competitive in global markets. This implies further substantial downward pressures on costs in the U.S. and on inflation. In short, continued corporate restructuring represents not only the nation's best hope for resolving our current trade problems, but also will keep inflation remarkably quiescent for the foreseeable future.■

Appendix
Productivity Trends and Restructuring in All Industries

	Average Annual Productivity Change			Restructuring Intensity Measure (RIM) (1980-1985 Average)
	1973 to 1980	1980 to 1985	Change in Trend	
MINING				5.8
Metal Mining				16.4
Iron Ore	1.4	8.1	6.7	
Copper	1.1	9.9	8.7	
Coal Mining	-1.6	6.5	8.1	2.5
Oil and Gas Extraction	NA	NA	NA	6.0
Nonmetallic Minerals, Except Fuels	-0.1	2.2	2.3	3.8
CONSTRUCTION	NA	NA	NA	0.0
MANUFACTURING	1.2	3.7	2.5	1.6
DURABLE GOODS	0.9	4.4	3.4	1.5
Lumber and Wood Products				2.2
Sawmill and Planing Mills	0.6	5.4	4.9	
Millwork	-1.3	-1.1*	0.2	
Kitchen Cabinets	2.4	-0.9*	-3.3	
Veneer and Plywood	2.3	3.2*	0.9	
Furniture and Fixtures				0.4
Household Furniture	0.4	2.0	1.6	
Office Furniture	3.1	0.8*	-2.3	
Stone, Clay, and Glass				0.9
Glass Containers	1.8	4.7	2.8	
Hydraulic Cement	-1.9	8.7	10.6	
Structural Clay Products	1.0	2.0	1.0	
Concrete Products	-0.3	1.7*	2.0	
Ready-Mixed Concrete	-1.5	0.7*	2.2	
Primary Metal Industries				1.5
Steel	-0.5	6.1	6.6	
Gray Iron Foundries	-0.6	3.8	4.3	
Steel Foundries	-0.3	-1.5	-1.2	
Primary Copper, Lead and Zinc	1.3	13.0	11.7	
Primary Aluminum	0.1	3.7	3.6	
Copper Rolling and Drawing	0.1	6.5	6.4	
Aluminum Rolling and Drawing	0.9	3.2	2.3	

*Productivity statistics are available through 1984 and are expressed in percentage changes.

Source: Morgan Stanley & Co. Incorporated, U.S. Department of Commerce and the Bureau of Labor Statistics.

Appendix — continued

	Average Annual Productivity Change			Restructuring Intensity
	1973 to 1980	1980 to 1985	Change in Trend	Measure (RIM) (1980-1985 Average)
Fabricated Metals				1.4
Metal Cans	3.3	4.2	0.8	
Hand and Edge Tools	-0.5	-1.9*	-1.4	
Fabricated Structural Metals	-1.4	0.9*	2.3	
Automotive Stampings	1.0	4.6*	3.6	
Metal Stampings	-0.3	-0.9*	-0.7	
Valve and Pipe Fittings	-0.1	0.4*	0.4	
Machinery, Except Electrical				1.0
Internal Combustion Engines	0.5	0.9*	0.4	
Farm and Garden Machinery	-0.2	1.1	1.3	
Construction Machinery and Equipment	0.5	3.2	2.7	
Machine Tools	-1.2	0.6	1.8	
Pumps and Compressors	0.3	1.1*	0.8	
Refrigeration and Heating Equipment	-1.3	2.1*	3.4	
Electric and Electronic Equipment				1.6
Transformers	1.9	-2.6	-4.5	
Switchgear and Swtichboard Apparatus	0.2	0.4	0.1	
Motors and Generators	-0.6	2.3	2.9	
Major Household Appliances	2.4	4.0	1.6	
Electric Lamps	2.0	4.1	2.2	
Radio and Television Sets	4.2	14.4*	10.2	
Transportation Equipment				1.6
Motor Vehicles and Equipment	0.8	6.2	5.3	
Instruments and Related Products				2.8
Instruments to Measure Electricity	2.6	3.9*	1.3	
Misc. Manufacturing Products	NA	NA	NA	1.5
NONDURABLE GOODS	1.5	2.8	1.3	1.8
Food and Kindred Products				3.8
Meat Packing	2.9	3.3	0.3	
Fluid Milk	5.3	3.8*	-1.4	
Preserved Fruits and Vegetables	1.1	2.2*	1.1	
Grain Mill Products	3.7	4.7*	1.0	
Bottled and Canned Soft Drinks	5.0	5.7	0.8	
Tobacco Manufacturers	1.9	2.4	0.5	2.2
Textile Mill Products				1.2
Hosiery	5.3	1.5	-3.9	
Nonwool Yarn Mills	2.3	5.3	3.0	
Apparel and Other Textile Products	NA	NA	NA	0.9

Appendix — continued

	Average Annual Productivity Change			Restructuring Intensity
	1973 to 1980	1980 to 1985	Change in Trend	Measure (RIM) (1980-1985 Average)
Paper and Allied Products				1.3
Paper, Paperboard, and Pulp Mills	2.0	3.0	1.0	
Corrugated and Solid Fiber Boxes	3.7	1.4	-2.3	
Printing and Publishing	NA	NA	NA	0.9
Chemicals and Allied Products				2.2
Synthetic Fibers	5.5	3.1	-2.4	
Pharmaceutical Preparations	3.2	1.8	-1.5	
Cosmetics and Other Toiletries	-0.6	0.2*	0.8	
Paints and Allied Products	3.0	3.7	0.7	
Petroleum and Coal Products				0.4
Petroleum Refining	0.1	1.3	1.2	
Rubber and Misc. Plastic Products				0.8
Tires and Inner Tubes	1.1	7.3	6.3	
Misc. Plastics Products	0.3	2.8*	2.5	
Leather and Leather Products				0.4
Footwear	0.1	1.1	1.0	
TRANSPORTATION AND PUBLIC UTILITIES				0.9
TRANSPORTATION				0.8
Railroad Transprotation				3.1
Railroad Transportation-Revenue	1.5	8.6	7.1	
Local and Interurban Mass Transit				0.2
Class I Bus Carriers	-0.7	-2.1*	-1.3	
Trucking and Warehousing				0.1
Intercity Trucking	-0.3	0.6	1.0	
Water Transportation	NA	NA	NA	1.4
Transportation by Air				0.6
Air Transportation	3.2	5.1	1.9	
Pipelines, Except Natural Gas				0.0
Petroleum Pipelines	-0.7	2.3	3.0	
Transportation Services	NA	NA	NA	0.9
COMMUNICATION				0.9
Telephone and Telegraph				NA
Telephone Communications	6.8	5.0	-1.8	
ELECTRIC, GAS, AND SANITARY SERVICES				0.9
Gas and Electric Utilities	0.4	-1.2	-1.6	

Appendix — continued

	Average Annual Productivity			Restructuring Intensity
	1973 to 1980	1980 to 1985	Change in Trend	Measure (RIM) (1980-1985 Average)
WHOLESALE TRADE				0.1
RETAIL TRADE				0.4
Retail Food Stores	-0.9	-1.3	-0.4	
Franchised New Car Dealers	0.5	2.0	1.5	
Gasoline Service Stations	2.7	3.5	0.9	
Apparel and Accessory Stores	2.6	5.3	2.6	
Eating and Drinking Places	-0.6	-1.4	-0.8	
Drug and Proprietary Stores	1.4	-1.2	-2.6	
FINANCE, INSURANCE, AND REAL ESTATE				0.9
Banking				2.1
Commercial Banking	-0.5	2.5*	3.0	
Credit Agencies Other Than Banks	NA	NA	NA	6.2
Security and Commodity Brokers	NA	NA	NA	1.8
Insurance Carriers	NA	NA	NA	4.6
Insurance Agents and Brokers	NA	NA	NA	0.4
Real Estate	NA	NA	NA	0.1
Holding and Other Investment Cos.	NA	NA	NA	7.6
SERVICES				0.3
Hotels and Other Lodging Places	0.4	0.4	-0.0	0.9
Personal Services				0.1
Laundry and Cleaning Services	-1.3	-0.7	0.6	
Beauty and Barber Shops	0.3	-0.7	-0.9	
Business Services	NA	NA	NA	0.7
Auto Repair, Services, and Garages	NA	NA	NA	0.1
Misc. Repair Services	NA	NA	NA	0.1
Motion Pictures	NA	NA	NA	3.7
Amusement and Recreation Services	NA	NA	NA	0.3
Health Services	NA	NA	NA	0.3
Legal Services	NA	NA	NA	0.0
Educational Services	NA	NA	NA	0.0
Social Services and Membership Organization	NA	NA	NA	0.0
Misc. Professional Services	NA	NA	NA	0.0
Private Households	NA	NA	NA	0.0

IRRC

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INTRODUCTION

In the ongoing debate over corporate takeovers, the use of non-investment grade debt, or so-called "junk" bonds, has been the subject of a great deal of attention and controversy. Several of the largest takeovers of the last few years, including the acquisition of Frontier Airlines by People Express and Ted Turner's buyout of MGM/UA Entertainment, were accomplished using junk bonds as the primary or sole source of financing. Several other, unsuccessful takeover attempts of blue-chip companies such as Phillips Petroleum and Unocal would have been considered unthinkable without the availability of junk bond financing.

Those who favor the use of junk bonds, including many investment bankers and takeover specialists, argue that the securities are a welcome addition to the takeover game because they eliminate sheer size as an obstacle to takeovers. Without the availability of junk bonds, proponents argue, there would be no practical way of obtaining the financing necessary for many of the larger takeover transactions. This argument is based on a belief that takeovers in general are beneficial to the economy because they weed out poor management and help allocate unproductive resources more efficiently. Junk bond proponents also point to the risk-reward ratio of the securities, which has been very favorable to investors over the last few years.

Critics, including many corporate executives, argue against junk bonds on two grounds: that the availability of junk bond financing facilitates what some view as an unhealthy phenomenon--the hostile takeover--and that junk bonds add a dangerous amount of risky debt to an economy that is already over-leveraged. Because junk bonds enable a bidding firm to go after a target many times its size, critics claim they provide corporate raiders an unfair advantage in the takeover game and thus facilitate hostile takeovers. These critics contend that hostile takeovers are counterproductive because they waste time and resources on activities that do not add any new products or services to the economy. Others worry that the junk bonds' high interest payments pose a high risk of default, which could cause serious damage in the financial markets when the next economic downturn arrives.

In response to these claims, several bills were introduced in Congress in 1985 that would have restricted junk bond issuance. Although two committees in the House of Representatives held hearings on junk bonds, the 99th Congress adjourned in October 1986 without enacting any legislation that would restrict the use of high yield securities.

However, in December 1985 the Federal Reserve Board emerged as a major player in the junk bond debate. The Fed announced Dec. 6 that it intended to extend its rules controlling the financing of securities purchases, or margin requirements, to certain transactions involving the issuance of junk bonds. Beginning in January 1986, shell companies set up as acquisition vehicles in hostile takeovers were prohibited from purchasing more than 50 percent of a target company's stock with funds secured through junk bonds. When the Fed ruling was announced, many experts in the field predicted it would be a major blow to the junk bond market.

However, data collected by IRRC suggest that the contrary is true--that the Fed's controversial rulemaking has had only a marginal impact on the use of junk bonds in takeover financing. IRRC found that at their peak, during the last six months of 1985, junk bonds represented 11 percent of the financing for tender offers covered in its survey. After the rulemaking, in the first nine months of 1986, they supplied less than 8 percent of such financing. Although this suggests that the ruling has caused some decline in the use of junk bonds in tender offer financing, industry experts say the major impact of the ruling has been more subtle; the major impact has not been the drop in the amount of junk bonds used to finance takeovers but a change in the way junk bonds are used to finance takeovers.

For example, IRRC learned, much more debt is now being issued by acquiring companies themselves, rather than by shell companies, to facilitate takeovers and circumvent the Fed ruling. Many of these issuers are borrowing in the junk bond market even before a takeover target is announced, to raise a "war chest" for takeovers. A case in point is Wickes Cos., which issued more than $1 billion in the junk bond market in 1986 for "acquisition purposes," according to a company spokesman. In other companies, the initial financing source may be internal funds or a bridge loan from a bank, but after a takeover is completed, junk bonds are issued to provide a long-term financing base. These takeover transactions do not appear in IRRC's survey as junk bond financing, but industry experts told IRRC that they currently dominate the hostile takeover market.

The impact of the Fed's ruling on the junk bond market will be examined in greater detail later in this report.

Sections of This Report

This report begins with a discussion of the development of junk bonds as a financing technique and examines the market for the bonds. Section II discusses the policy implications for restricting junk bond financing of takeovers. The third section describes the Fed's ruling and the public response to it. Section IV analyzes the effects of the ruling through a systematic study of tender offers launched before the ruling compared with those begun in 1986.

The last section of this report discusses the new policy debate involving junk bonds—their safety as investment vehicles. This debate intensified dramatically in recent months as a result of speculation that Drexel Burnham Lambert, the driving force behind the junk bond market, and Michael Milken, Drexel's key executive involved in junk bonds, could be named as defendants in the ongoing Ivan Boesky insider trading scandal. This section of the report also includes a discussion of the likely fallout from the Boesky scandal for junk bond investors.

This report was written by Howard D. Sherman and Ronald E. Schrager, senior analysts with IRRC's Corporate Governance Service.

I. HISTORY AND EVOLUTION OF JUNK BONDS

The term "junk bonds" refers to all debt instruments, including but not limited to those used to finance takeovers, that encompass both high risk and high yields. Because of their riskiness, junk bonds trade at high premiums, sometimes as much as five percentage points, over Treasury securities.

The strict definition of junk bonds is those debt instruments that are either rated below investment grade by the major bond rating agencies, Standard & Poor's and Moody's, or are not rated at all by either agency. For Standard and Poor's, the below investment grade ratings are BB, B, CCC, CC and C; for Moody's they are Ba, B, Caa and Ca. The letter ratings may be modified by the addition of a plus or minus sign within each category.

At the time a company decides to float a bond, the two rating agencies assess the financial position of the issuer and make a determination about the ability of the issuer to pay interest on the debt and to repay the principal at maturity. According to Standard and Poor's Credit Review:

> Debt rated less than investment grade is regarded, on balance, as predominantly speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. BB [Ba for Moody's] indicates the lowest degree of speculation and C [Ca for Moody's] the highest degree of speculation. While less than investment grade debt will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions....While the market has shown a strong appetite for below investment grade debt, it has a fairly strong aversion to the most speculative issues, debt rated in the CCC category or lower. Recent growth in the new issue junk bond market has not, for the most part, encompassed debt rated below B-.

Fallen Angels

Traditionally, all debt underwritten by the major investment banks was investment grade at the time of issuance. A small market for high yield, high risk bonds did exist, however, because some companies, referred to as "fallen angels," had their debt obligations downgraded after they experienced financial difficulties. After these bonds were downgraded, they traded at a discount and their yields rose to reflect the added credit and default risk. The higher yield securities came to be known by the derogatory name "junk bonds."

In 1977, Lehman Brothers developed the idea of underwriting new issues of debt securities from companies that could not qualify for an investment grade bond rating. Lehman, however, withdrew from the business shortly thereafter. Drexel Burnham Lambert, at the time one of the smaller investment banks on Wall Street, seized on Lehman's idea of specializing in new issuances of high yield bonds and began to underwrite scores of them. While the Drexel instruments differed substantially from the so-called fallen angels, the epithet "junk bonds" was attached to the new type of high yield bond issuance as well.

The Role of Drexel

Drexel has been extremely successful in developing its junk bond business because it correctly assessed both the need for a new corporate financing technique and investors' growing demand for high yield securities. Because the bond rating agencies tend to emphasize historical financial performance and size in assigning bond ratings, the vast majority of newer and smaller companies cannot qualify for high bond ratings. According to Drexel, of all companies with assets in excess of $25 million, fewer than 5 percent of them are able to issue investment grade debt. Before the advent of new issuance junk bonds, cash-starved smaller and newer businesses had been forced to seek loans from banks or private term loans from other institutions such as insurance companies in order to raise capital.

By creating a market for high yield securities, Drexel realized it could provide a much more efficient means for these companies to acquire capital. For example, their traditional financing source--bank loans--generally requires faster repayment, typically over seven years as compared to 10 to 20 years for high yield securities. In addition, bank lenders frequently require debt-to-equity ratios that are difficult for companies to achieve without lowering the debt outstanding through the sale of assets. High yield debt securities generally provide more flexible structuring.

New issue junk bonds also enabled Drexel to respond to the desires of some of its investor clients to diversify their portfolios to include bonds that yielded above-market rates. High yield bonds can be attractive because it is possible for investors not only to profit from the higher interest rates, but to experience in some cases substantial price appreciation that occurs when an issuer's financial position improves and the bonds are upgraded. Because they have both a potential for price appreciation and an earnings component, junk bonds have many similarities to equity securities. Junk bonds differ from investment grade bonds in that their price fluctuations are more closely linked to the financial performance of the issuer than to general market interest rates.

Since 1977, the volume of new issue junk bonds has increased dramatically. In 1984, a total of $14.3 billion in junk bonds was floated in public offerings, compared with $900 million in 1977. The vast majority of junk bonds issued during this period were underwritten by Drexel. Junk bond issuance increased to about $15 billion in 1985 and to $16 billion in the first half of 1986 alone, according to the Investment Dealers' Digest. Salomon Brothers estimates that corporate debt rated below investment grade rose from 11 percent of the total debt issued in 1982 to more than 24 percent in 1985.

Other banks, lured by Drexel's success with junk bonds and the high underwriting fees bankers command for high yield debt, recently have made greater inroads into the junk bond business. The Wall Street Journal reported that Drexel handled less than 60 percent of the junk bonds issued in 1985, compared with about 73 percent a year earlier. Most of Drexel's competition has come from Merrill Lynch, Shearson Lehman Brothers, First Boston and E.F. Hutton.

Junk Bonds in Hostile Takeovers

The high yield bond market underwent a dramatic change in early 1984 when Drexel offered to arrange a junk bond issuance for T. Boone Pickens Jr. to raise money for his attempted takeover of Gulf Oil, and junk bond financing and hostile takeovers were wed for the first time. Drexel was able to arrange $2 billion in financing for Pickens's Gulf bid; no bonds were issued, however, as Gulf was subsequently acquired by a white knight, Chevron. Since then, junk bonds have played a key role in several hostile takeover attempts, and takeover-related high yield bond issuances have become more common.

A junk bond takeover typically works as follows: The potential acquirer sets up a shell corporation that serves as a vehicle to acquire the stock of the target company. The shell company makes a tender offer--often a two-tier offer--for the stock, which is usually conditional on the acquirer arranging financing for the offer. In the meantime, the acquirer's investment banker--Drexel or one of its competitors--begins to solicit commitments from investors to purchase junk bonds that will be floated by the shell corporation to raise cash for the tender offer. The acquirer pays commitment fees to all investors promising to purchase the bonds, which can run as high as 2 percent of the face value of the bonds to be purchased.

Once the financing for the first tier of the tender offer is arranged, the acquirer's shell company issues high yield bonds that are placed with the investors previously committed to purchasing them, and uses the cash from the placement to begin purchasing shares tendered. After the acquirer gains control in the first tier, often the second tier of the tender offer will involve a second issuance of junk bonds that are exchanged for the stock held by the remaining shareholders and are placed directly with those shareholders. These second-tier bonds usually are subordinate to those issued in the first tier.

Because the assets of the company acquired in the offer generally are used to back the bonds that the acquirer issues, raiders often are forced to sell off some or all of the company's assets to repay the debt incurred in the takeover. Hence the name "bust-up" hostile takeovers. In other cases, some of the debt can be serviced from the cash flow of the target company. Thus, the outcome of junk bond takeovers usually depends on both the creditworthiness of the raider and on his ability to find a company that is underleveraged.

Performance of High Yield Bonds

Many investors avoid purchasing high yield bonds because of their speculative nature. Especially when the securities are issued in connection with a takeover, there is no track record by which to gauge the emerging, highly leveraged firm's ability to service its interest and principal repayment obligations.

The evidence to date suggests that the risk of investing in junk bonds is genuine. For example, a June 1986 study by Dr. Edward Altman of New York University, sponsored by Morgan Stanley, found that the default rate on high yield bonds from 1974 to 1985 averaged 1.5 percent of par value, compared with a 0.13 percent default rate for corporate debt overall. Studies by Drexel Burnham Lambert similarly report a higher default rate for high yield securities than for corporate debt overall.

It is worth noting that none of the studies to date has attempted to analyze the default rate of takeover-related junk bonds issued in the past year and a half, which constitute a significant portion of high yield securities now outstanding. One would expect to see a higher default rate for these securities in the next economic downturn. Some preliminary evidence from 1985 indicates that the default rate for junk bonds already may be increasing. The Feb. 17, 1986, issue of Business Week reported that junk bond defaults in 1985 exceeded $1 billion for the first time, up from about $250 million in 1984. The defaults were largely due to the economic downturn in the oil industry.

The bankruptcy of LTV Corp., the nation's second biggest steel company and one of the largest junk bond issuers, in July 1986 added more fuel to the fire. Some LTV notes dropped a full 50 percent immediately after the Chapter 11 filing. Junk bond critics contend that LTV was only the first of a series of defaults expected in troubled industries. One critic noted in High Performance that he "would not be surprised to see a two-tier market emerge if credit problems multiply."

However, to look at just the default rate on junk bonds and conclude that they are too risky is to miss the whole picture. Modern investment theory is based on the risk-reward relationship--the premise that investors demand and receive higher rewards (i.e., higher yields or "risk premiums") when making risky investments. Investment decisions boil down to deciding whether a given security offers a fair return relative to its level of risk. Empirical studies on returns in the junk bond market suggest that the risk-reward relationship of junk bonds has been very favorable to investors.

In addition, the risk associated with holding one company's junk bonds in isolation can be reduced through portfolio diversification. Because most of the risk of junk bond default is firm-specific, much of it can be eliminated through a canceling-out process by holding a variety of bonds in a portfolio. Research from Morgan Stanley indicates that a 10-bond portfolio achieves 90 percent of the attainable risk diversification, while a 40-bond portfolio eliminates about 97 percent of the risk of loss from default.

A December 1984 study by Marshall Blume and Donald Keim of the Wharton School of Finance and Commerce of the University of Pennsylvania serves as a good example of the major findings of junk bond research. Blume and Keim constructed an index to measure the risk-reward relationship of junk bonds over the period January 1980 through June 1984. Not surprisingly, the study showed that below-investment grade bonds generated much higher yields than AAA-rated bonds, 20.3 percent annually versus 15 percent, and outperformed the stock market as well. The study also found that the volatility of the lower-grade securities (as measured by the standard deviation of monthly returns) was less than that of both higher-grade corporate bonds and equities. This result was somewhat surprising, and the authors concluded that even though "lower quality bonds are individually risky,...much of this risk is firm-specific and can be eliminated through diversification. If so, a portfolio of such lower-quality bonds may represent a conservative investment, even though each component is highly volatile."

To determine the risk-reward characteristics of a junk bond portfolio, Blume and Keim used the so-called alpha coefficient, a commonly used measure of investment performance developed under the capital asset pricing model. In brief, a positive alpha means that a security's return is in excess of the return which would be warranted by the risk level of the investment. The study found that the alpha coefficient for both low and high grade bonds was positive, with the alpha for the lower quality bonds the highest — 0.61 percent versus 0.24 percent for investment grade debt. These results indicate that not only do junk bonds provide returns commensurate with their level of risk, they provide an excess risk premium.

Blume and Keim conclude that if the time period covered is predictive of the future, then high yield bonds deserve a place in even a conservative investment portfolio. However, the authors warn that the accuracy of their results "depends upon the length of the period analyzed, and four and a half years is a short period to estimate such statistics." In addition, since the time frame of the Wharton study was one of stable economic conditions, it is probable that the risk-reward relationship of junk bonds will deteriorate in the next economic downturn.

Investing in Junk Bonds

The market for junk bonds often is referred to as a private market, with Drexel Burnham Lambert as the driving force. As previously mentioned, Drexel all but invented the new-issue junk bond market, and has developed a broad clientele of willing buyers. In addition to its contact lists, Drexel plays a key role in the market by ensuring that there is a secondary market for the purchase and sale of previously issued high yield bonds. Because these bonds tend to be lightly traded, Drexel's role in increasing the liquidity of junk bonds has greatly expanded the number of investors willing to buy new issuances.

When Drexel began dealing in junk bonds, the major purchasers of the securities were a small network of highly sophisticated, wealthy individual investors. As junk bonds began to play a role in takeovers, the Drexel network came to include many corporate raiders who also issue bonds. Some of the more famous players in the junk bond market include Irwin Jacobs, T. Boone Pickens, Saul Steinberg, Victor Posner, Kirk Kerkorian (former controlling shareholder of MGM/UA Entertainment), Stephen Wynn (chairman of Golden Nugget), Charles Knapp, Fred Carr (head of First Executive Corp.) and Thomas Spiegel (president of Columbia Savings & Loan).

Critics of junk bonds contend that because there exists a high degree of overlap between those who issue junk bonds and those who invest in them, the junk bond market's liquidity may not be as deep as would be assumed. This could be a problem for small, relatively unsophisticated investors. If a junk bond issue is heading for trouble, the "smart money" will know when to bail out—Drexel doesn't want to lose important clients. Small investors could be left holding "zombies"—bonds in default.

The Boesky insider trading scandal, which broke in November 1986, also points to another weakness of the junk bond market: its dependence on Drexel Burnham and Drexel's head dealmaker, Michael Milken. Junk bond prices dropped precipitously in the days immediately following the Boesky scandal, when Drexel and Milken were named as possible defendants. Investors worried that without Drexel, the market's liquidity would dry up. The junk bond market has since recovered from the initial rumors concerning Drexel and Milken, but could fall again if Drexel eventually is implicated in the Boesky scandal.

Institutions, once hesitant to invest in junk bonds, have become major purchasers of high-yield securities in the last two years. Commitment fees act as a secondary incentive for these investors, since the fees are paid whether or not the bonds are issued. The institutional market is represented by a broad range of players, including public and private pension funds, investment managers, savings and loans and insurance companies. Numerous mutual funds also have begun investing in junk bonds. According to Lipper Analytical Services, 50 major funds with assets totaling $20.7 billion were investing primarily in junk bonds as of June 30, 1986.

Many institutional investors have limited their activity in the junk bond market either because of self-imposed restrictions or government regulation. For example, some institutions, particularly corporate pension funds, will invest in junk bonds but not when such bonds are issued in conjunction with hostile takeover bids. Some public pension funds are legislatively prohibited from purchasing junk bonds, while other fund managers refrain because they do not consider the bonds a prudent investment. The insurance laws of many states limit the amount of junk bonds insurance companies can purchase. Conflicts of interest also may be involved in junk bond financing of takeovers. For example, insurance companies might be hesitant to purchase junk bonds from a raider for fear the defeated directors who sit on other companies' boards might pressure these companies to take their insurance business elsewhere.

Some of the largest savings and loan associations also have begun to purchase junk bonds, but thrifts' activity in this area has been restricted by the Federal Home Loan Bank Board. As a general rule, all debt securities purchased by S&Ls must be investment grade. The Bank Board allows S&Ls to purchase a limited amount of high yield debt if prudent business judgment is exercised. Several members of Congress have expressed concern over S&L activity in the junk bond market, attempting to link junk bond purchases to bank failures. The House Banking Committee considered the S&L question in hearings held in the fall of 1985, but no legislation was introduced. However, the hearings did help spur the Bank Board to tighten somewhat its restrictions on S&L investing.

II. POLICY IMPLICATIONS OF RESTRICTING JUNK BONDS

By moving to restrict the issuance of junk bonds in takeovers, the Board of Governors of the Federal Reserve was responding to concerns about the desirability of continued increases in the volume of high-yield securities issuances. This section summarizes the arguments for and against limiting junk bonds, and discusses congressional moves to limit the issuance of high-yield bonds.

Arguments in Favor of Restricting Junk Bonds

Many of the arguments against junk bonds are based on arguments made against hostile takeovers in general. Some critics argue that hostile takeovers are wasteful because they employ vast amounts of economic resources and available credit for little or no useful purpose. It is argued that the threat of a hostile takeover pressures corporate managers to behave myopically by sacrificing long-term benefits to increase short-term profits. A similar argument made against takeovers is that managers under siege are forced to spend a great deal of time defending against unwanted takeover offers at the expense of the day-to-day management of the company. Still others argue that takeovers have a harmful impact on corporations, their suppliers, their customers and the communities in which they operate, and have adverse employment effects.

To these observers, junk bonds are inherently undesirable because they greatly enhance the ability of raiders to make hostile offers. The power that raiders gain by virtue of the ability to raise large amounts of cash by issuing bonds cannot be underestimated. A few years ago, the prospect of an individual—Carl Icahn—raising $8 billion to acquire Phillips Petroleum was unthinkable. No bank or group of banks would advance such a large amount of funds to an individual. The collateral—the target company's assets and cash flow—was too risky; it was conditioned on the deal going through. With junk bonds, raiders are able to launch bids that are conditional upon arranging financing, so companies can be put into play well before a potential acquirer has proven that he has the financial wherewithal to make good on his acquisition proposal. Critics contend that this gives raiders an incentive to make even frivolous bids because they can profit greatly from the emergence of a white knight who purchases the company at a premium, or from a greenmail payment. Thus, the argument goes, the availablity of junk bond financing tips the balance in the takeover game heavily in favor of corporate raiders.

A second school of thought holds that while takeovers may not be inherently harmful to the economy, junk bond financing is. Critics have been especially disturbed by high-yield bonds issued to shareholders in exchange for their shares in the back end of a two-tier offer. (In a two-tier offer, a company acquires a controlling interest in its target at one price, then in a second offer purchases the remaining shares for what is usually a lower price than the first stage.) They argue that, on average, the quality of the debt issued to the unknowing shareholders is low and it is unfair to saddle individual shareholders with such a high-risk financial instrument. Some have even gone so far as to argue that the bonds are of such low quality that even sophisticated institutional investors should be prohibited from purchasing them, lest poor economic times cause a rash of junk bond failures.

Other critics have focused on larger issues involving debt in the economy. They contend that there has been an alarming increase in the amount of debt in society, and they have targeted junk bonds as an area to reduce debt. Junk bonds, it is argued, may have performed well in the relatively strong economic times of the mid-1980s, but they would default in droves in a severe recession. Felix Rohatyn, for example, has said that interest payments on junk bonds would exceed the average level of return on assets during a recession. Thus, he argues, companies would be forced to sell assets to retire their high yield bonds if there were a recession. Rohatyn and others fear that massive failures of junk bonds could set off a chain reaction that would severely damage the economy at large.

Arguments Against Limiting Junk Bonds

Just as the arguments for limiting junk bonds tie into the larger debate about takeovers in general, so do the arguments against such limitations. Many takeover proponents argue that when the internal control processes for change in large corporations are too slow, costly and clumsy to accomplish efficiently the required restructuring or change in managers, it is the stock market, through the competition for corporate control, that brings about the necessary changes. Others say that if a corporate raider is willing to pay a premium for the shares of a company's stock, the reason is probably that the company's assets were not being utilized to their most efficient ends. A raider who purchases a company and redeploys its assets, either by selling them or by changing management, actually is providing a socially useful service by improving efficiency, this argument goes.

To takeover proponents, junk bond financing of takeovers is not a harmful development. Before high yield securities were used in conjunction with takeovers, raiders were unable to target large companies simply because they could not raise enough money to finance their bids. It is argued that sheer size should not protect entrenched managers from the pressure to manage their companies efficiently that is caused by the fear of a change in control.

In response to those who question the quality of junk bonds and wish to restrict them on these grounds, proponents of junk bonds contend that market forces will correct for any severe run of potential high yield bond failures. Purchasers of junk securities are generally sophisticated investors capable of analyzing the financial position of the party issuing the bonds before they commit to purchasing any high yield securities, it is argued. Takeovers that are not economically sound, the argument usually goes, will not receive financing and thus will not be completed.

Proponents of junk bonds often cite the recent examples of Icahn's attempted acquisition of TWA and Turner's takeover of MGM/UA Entertainment as examples of market corrections that occurred without regulation. In the TWA case, Icahn bought majority control of the company on the open market and installed himself as chairman. He then attempted to secure financing to purchase the remaining shares of the company to take the company private. At the same time, TWA's financial condition was deteriorating, and Icahn found it more and more difficult to attract purchasers for his junk bonds. Eventually he abandoned his efforts to freeze out the minority stockholders. He remains chairman and principal shareholder but has been unable to obtain junk bond financing to buy out other shareholders.

In the MGM/UA case, Ted Turner offered to purchase the company in a transaction involving no cash down. Like Icahn, he also had difficulty in finding purchasers for the junk bonds he needed to sell to finance the cash part of his offer. Turner was forced to lower the price of his offer three times before the deal was consummated. Many observers pointed to this case as an example of the market adjusting to changing conditions. Turner amended his offer to tailor it to the market perceptions of a value that was within his financial capabilities.

Free-market proponents also have responded to the cries that junk bonds contribute to the excessive levels of debt in the U.S. economy. Their major response has been that if regulators are worried about reducing debt, restricting junk bonds, which account for such a small percentage of debt in the economy, would not have as much of an impact as other remedies, such as changing the tax code to eliminate the tax-favored status of debt. Estimates from the Federal Reserve indicate that takeover-related borrowings increased the amount of nonfinancial debt outstanding by only one to one and one-half percentage points in 1984. Proponents also add that increased debt can even have a beneficial impact on a company because the larger debt service forces managers to allocate company resources more efficiently.

Congressional Action

By mid-1985, the debate surrounding junk bonds had heated up enough to stimulate congressional hearings on proposals to curb junk bonds. The most publicized bill was introduced by Sen. Pete V. Domenici (R-N.M.) in April. The bill (S 975) would have established a ban through Dec. 31, 1985, on hostile takeovers that were at least 20 percent financed by junk bonds. It also would have indefinitely prohibited federally insured banks from adding below-investment grade securities to their portfolios.

In support of the bill, Domenici stated that in the event of a recession, the new managements of takeover targets "may experience difficulties in servicing the speculative debt." The leveraging of corporate America, he added, "may result in significant bankruptcies for corporations and banks tomorrow." Domenici said the bill would "buy time for us to examine the complexities surrounding" junk bond financed takeovers.

Another approach to limiting junk bonds was proposed in several bills introduced in the House of Representatives. The aim of these bills (HR 1100, HR 2476) was to halt junk bond use by denying tax deductions for interest on high yield securities. These bills would have been far-reaching in light of estimates indicating that Icahn would have realized about $600 million in tax savings had his proposed Phillips Petroleum acquisition been successful.

Several Senate and House committees held hearings in 1985 at which junk bond restrictions were debated. However, proponents of legislation to curb junk bonds never were able to muster sufficient support to move any bills out of committee. When Congress failed to enact legislation, the stage was set for the Fed to step in with junk bond restrictions of its own.

III. FEDERAL RESERVE BOARD RESTRICTIONS

On Dec. 6, 1985, in response to issues raised in the Mesa Petroleum/Unocal takeover battle and the Pantry Pride/Revlon contest, the Federal Reserve Board issued for public comment an interpretation of Regulation G, which would apply federal margin requirements to certain kinds of junk bond acquisitions. By a 3 to 2 vote, the Fed said it would solicit public comments on the controversial proposal until Dec. 23, and the proposal would take effect on Dec. 31.

While the proposal was received with enthusiasm by many corporate managers and some congressmen, several prominent players in the takeover debate immediately went on record as opposing the rule interpretation as well as the short comment period. This group included the Reagan administration, several takeover artists, including T. Boone Pickens, and two Reagan appointees to the Federal Reserve's Board of Governors.

The Fed justified its reinterpretation by arguing that bonds issued by a shell corporation during a takeover battle are indirectly secured by the stock being purchased with the proceeds of the bonds. While the Board of Governors eventually adopted the rule interpretation by another 3 to 2 vote, the final scope of the proposal was toned down somewhat from its original form in response to the numerous criticisms received during the comment period.

Background on Margin Rules

Since 1930, the Fed has been authorized to set margin requirements, which are intended to curb rampant speculation in the stock market by limiting the amount of debt a purchaser of stock can incur in conjunction with the purchase.

The relevant section of Regulation G reads, in part: "No lender...shall extend any purpose credit (credit extended for the purpose of buying margin stock) secured directly or indirectly by margin stock in an amount that exceeds the maximum loan value of the collateral securing the credit."

The maximum loan value of margin stock under Regulation G is 50 percent. The December 1985 proposal specifically interpreted the margin rules in such a way that the 50 percent credit limitation would apply to junk bonds issued by shell companies set up as acquisition vehicles by raiders to purchase stock in a target company.

The Fed said the reinterpretation was warranted because shell corporations "have virtually no business operations, no significant business functions other than to acquire and hold the shares of the target company, and substantially no assets or cash flow to support the credit other than the margin stock that it has acquired or intends to acquire." Therefore, the Fed reasoned, "the debt securities issued by such a shell corporation are indirectly secured by the stock to be acquired and are thus subject to the margin regulations."

The proposal stipulated that the requirement would not apply when debt securities are guaranteed by the parent of the shell company because in these cases the parent guarantee is the security, not the stock being purchased, so these deals fall outside the scope of Regulation G.

The proposal added that the Fed planned to examine each junk bond issuance individually to determine whether it fell within the scope of the new rule. For example, the Fed might decide that a small company that attempted to acquire a company many times its size was a "shell equivalent" that would be subject to the margin requirements. The Fed also might consider other characteristics of the financing used in a takeover bid, such as the terms of the securities issued and how long before the takeover the financing was arranged, in determining whether its margin requirements applied to the credit arrangement.

The Federal Reserve Board's decision to adopt the proposal was somewhat ironic because the Fed had testified previously before Congress that its margin requirements as a whole were no longer needed in today's capital markets. A 1984 Fed staff study showed that the margin requirements no longer prevent speculation because of the existence of markets for options, indexes and futures.

Response to the Proposal

The Fed proposal drew immediate criticism from many quarters, both for the subject matter of the ruling and for the way it was handled--that is, without a lengthy public comment period. Some of the strongest attacks came from the Reagan administration, which consistently has opposed on free market grounds any new rules that restrict takeovers. Speaking for the administration, Margery Waxman, deputy general counsel of the Treasury Department, told The Wall Street Journal the new rule interpretation was unjustified because "there are sufficient investor protections in the current securities laws."

In addition to the Treasury Department, the Securities and Exchange Commission recorded its opposition to the rule interpretation. In a public comment, the SEC stated that the restrictions might encourage an increase in takeovers by foreign companies that would not be covered by the Fed's margin requirements. It added that allowing the Fed to make a determination on whether a takeover vehicle constituted a "shell equivalent" might impede some time-sensitive takeover bids. Other executive branch agencies opposing the proposal included the Department of Justice, the Office of Management and Budget, the Department of Labor, the Commerce Department and the Council of Economic Advisers.

Also commenting extensively on the proposal was Rep. (now Sen.) Timothy E. Wirth (D-Colo.), who chaired the House subcommittee with jurisdiction over federal securities law. In a letter to Fed Chairman Paul Volcker dated Dec. 5, 1985, Wirth expressed "deep concern about the growing levels of private and public debt" in the economy and said he agreed with the Fed's intention to curb the use of junk bonds in hostile takeovers. However, he urged that the Fed issue the proposal through a formal rulemaking rather than simply as a reinterpretation of an existing rule. By following a rulemaking procedure, Wirth asserted, the Fed would "provide an assurance of procedural fairness to those potentially adversely affected by the Board's action," and would receive "the benefit of more extensive comment by those who believe the Board should act in this area." Volcker responded to Wirth by agreeing to institute a short public comment period.

Early response to the Fed proposal on Wall Street was mixed. Many feared the proposal was simply the first step in efforts by federal agencies to put a damper on the active takeover market. Some analysts speculated that the new rules would spur a rash of takeover bids before the end of the year, when the new rules were to take effect. On the other hand, several securities lawyers and investment bankers seemed confident that while the rule might restrict somewhat the use of junk bonds, raiders would find ways to circumvent it. In an interview with The New York Times, Pickens concurred with these observers, stating that although the rule would make it more complicated for a raider to obtain financing, "There will always be some ways for people with resources to make offers. If otherwise you could do a $5 billion deal, it may cut you down to where you can only do a $2 billion deal."

Frederick Joseph, the chief executive officer of Drexel Burnham Lambert, was one of the most vociferous opponents to the rule change. Joseph estimated that if the Fed proposal had been in effect in 1985, Drexel's revenues would have declined by about 5 to 10 percent.

Other players in the takeover game, including business groups such as the Business Roundtable and the National Association of Manufacturers and the lawyers that represent target companies, supported the proposal as a necessary first step toward government regulation of abusive tactics used by corporate raiders. Takeover attorney Martin Lipton, who represents target companies against hostile takeover attempts, told The New York Times he was "pleased that the Fed has accepted the basic position we urged," but he said he was "disappointed that the Fed has not really eliminated this scourge of the junk bond takeover."

Scope of the Proposal

On Jan. 8, 1986, the Fed announced it had adopted the final interpretation of Regulation G by another 3 to 2 vote, with an effective date of Jan. 10. It is clear that the vigorous criticisms received during the comment period helped dilute the impact of the final ruling.

In its announcement, the Fed specified four general types of acquisitions that would not be subject to the margin requirements of Regulation G: those involving (1) operating companies with substantial assets or cash flow, (2) guarantees by companies with substantial assets or cash flow, (3) agreed-upon mergers, and (4) statutory "short-form" mergers (those where no shareholder or board approval is necessary). These four exemptions were based on the board's view that the rationale supporting the interpretation ("reasonable cause to believe that lenders are relying for repayment on the margin stock") would not cover these types of acquisition arrangements, even if debt securities were issued by a shell corporation that was used as an acquisition vehicle.

For example, even when a shell corporation is involved, the ruling presumes that lenders would not be relying on the stock being purchased for repayment when the bonds are issued by an operating company with substantial assets or cash flow or are guaranteed by an operating company with the same characteristics. Similarly, the ruling presumes that lenders would not be looking to the stock being purchased for repayment if there were a merger agreement between the acquiring and target companies or in the case of a statutory short-form merger, even when a shell corporation is involved. These amendments seemingly exempt junk bond-financed leveraged buyouts, which are generally done on a friendly basis, and other friendly deals involving junk bonds.

The limited scope of the Fed ruling obviously left room for numerous alternative takeover financing arrangements. Merger deals or tender offers could involve swaps of equity rather than junk bonds. Raiders could secure their junk bonds with assets other than the stock to be acquired with the bond proceeds, such as assets of other companies they control. Bonds also could be issued directly by companies with assets that are affiliated with the raider. A shell corporation could issue preferred stock to secure the debt rather than securing it with stock in the target company. However, convertible preferred, especially if convertible at the issuer's option, is in substance very similar to debt instruments. It is possible the Fed could choose to apply its margin requirements to convertible preferred issued in conjunction with a hostile takeover. To date, this issue has not been addressed by the Board of Governors.

Given the numerous scenarios in which takeovers in general and takeovers involving junk bonds, specifically, could occur under the new rules, it remains to be seen what, if any, impact the Fed ruling has had on takeover activity. The next section uses empirical evidence in examining the effects of the Fed junk bond rule on takeovers in 1986.

IV. IMPACT OF THE FED RULING

Takeover professionals believe that the Fed ruling has had little or no impact on the role of junk bonds in takeover financing.

Irwin Jacobs, who used junk bonds to help finance Minstar's acquisition of AMF in 1985, told IRRC the Fed ruling "has not interfered at all with our situation. People out there with an ongoing business are not affected by the ruling—only shell corporations."

Similarly, a takeover specialist at the Washington law firm of Squires, Sanders and Dempsey told IRRC that the initial uproar over the Fed ruling was "much ado about nothing." He added: "The ruling didn't apply to that many situations in the first place, only to deals involving shell companies. The boom in the stock market and the new tax law probably have had much more of an impact on the takeover market than anything the Fed has done."

A spokesman for Drexel Burnham Lambert told IRRC the true impact of the Fed ruling has been to change the way companies use junk bonds to finance takeovers. He said the ruling has encouraged more acquiring companies "to issue junk bonds themselves, rather than through a shell corporation." According to the spokesman, these companies are turning to Drexel for financing even before they have an acqusition target in mind, just to raise a "war chest for acquisition purposes."

The Drexel spokesman also told IRRC there has been an increase in the use of bridge loans from commercial banks to finance takeovers. These bank loans are paid off within a few months of a completed takeover with proceeds from a junk bond issuance. Transactions such as these do not fall within the scope of the Fed ruling.

Another impact of the ruling has been an increase in the use of preferred stock as a financing source for tender offers, according to industry experts. Randall Smith of The Wall Street Journal reported on Aug. 18 that: "The Fed watered down the rule enough that it comes into play in very few takeover situations. Even on the odd occasion when it does, raiders have easily sidestepped it by offering preferred stock, which acts like debt in most respects but which counts as equity." For example, in the $487 million takeover of Warnaco in late April, takeover attorney Martin Lipton told the Journal, "The raider's investment banker was able to circumvent the rule simply by raising half the financing as common and preferred stock and the other half as debt. Not surprisingly, following the announcement of a merger agreement, most of the equity financing was converted into debt."

To verify these impressions, IRRC conducted a survey of tender offer financing over the last few years, with the goal of determining how the use of junk bonds in takeover financing has changed since the Fed ruling. The survey incorporates data gathered by the Securities and Exchange Commission for a paper released in June, Noninvestment Grade Debt as a Source of Tender Offer Financing. IRRC's analysis confirms that the Fed ruling has had only marginal effects on the use of junk bonds in takeover financing.

The SEC Study

The SEC study examined the changing role of debt in takeover financing over the period October 1981 to July 1985. It was written by the commission's Office of the Chief Economist, known for its free market views. The study concluded that by July 1985, there had been a marked increase in the use of junk bonds to finance takeovers, but that the absolute level of junk bond financing was lower than many observers believed.

The SEC found that debt issues represented only 0.3 percent of tender offer financing for the years 1981 through 1984. For the period Jan. 1 to July 1, 1985, debt issues had grown to represent 13.6 percent of tender offer financing. While this was a large change from prior years, the SEC said the absolute amount of debt issues used to finance tender offers in the first half of 1985 was only $2 billion out of a total $14.7 billion in total financing needs. Therefore, the SEC concluded, although the use of debt had increased in importance in tender offer financing by mid-1985, the absolute level of such financing was well below what the public seemed to believe, given all the attention junk bonds were receiving in the financial media.

It is important to note that the SEC assumed that all debt issued in connection with a tender offer was below investment grade. This means the actual level of junk bond financing almost certainly was lower than the SEC study indicated.

The SEC report concluded that "junk bond takeover financing should be regarded as an innovative reaction by financial markets to specialized financing needs." In addition, it said: "...We argue that there is no cause for excessive concern about current levels of junk bond financing in takeovers. Nor is there justification for new regulatory initiatives aimed at curbing the use of this kind of debt issuance in takeover bids or indeed as it relates to any other aspects of corporate financing activity."

IRRC's Survey

The SEC's study ended before the Fed ruling took effect. In order to evaluate the impact of the ruling on the junk bond market, IRRC performed two types of analyses. One was to extend the SEC data base to cover tender offers completed through Sept. 30, 1986. In this analysis, IRRC used the same methodology as the SEC study. Both cover only successful cash tender offers for target companies with a market capitalization of $100 million or more. Financing information was obtained from public sources, including 14D filings that state the terms of the offer. In cases where the financing information was unclear, IRRC contacted the company directly to verify its financing sources. The studies use four categories of takeover financing sources: internal funds, bank borrowings, equity issues, and debt issues. In this analysis, as in the SEC's, all debt issues are assumed to be junk bonds.

The combined results of the SEC and IRRC surveys are presented in the chart on page 17. One trend is obvious: Debt issues became an increasingly important source of tender offer financing in 1985 and the first nine months of 1986. Debt issues represented only 0.3 percent of tender offer financing for the years 1981 through 1984. The levels

Tender Offer Financing Sources

($ in billions, percentages in parentheses)

	1981	1982	1983	1984	1985*	1986**
Debt Issues	$ 0.0	$ 0.1	$ 0.0	$ 0.1	$ 4.3	$ 6.8
	(0.0)	(1.1)	(0.0)	(0.3)	(15.9)	(29.0)
Bank Borrowings	$14.7	$ 7.4	$ 5.0	$24.0	$19.6	$13.8
	(50.5)	(78.7)	(86.2)	(83.0)	(72.3)	(58.7)
Internal Funds	$ 5.5	$ 1.3	$ 0.8	$ 4.3	$ 2.7	$ 1.7
	(47.1)	(13.8)	(13.8)	(14.9)	(10.0)	(7.3)
Equity Issues	$ 0.7	$ 0.6	$ 0.0	$ 0.5	$ 0.5	$ 1.1
	(2.4)	(6.4)	(0.0)	(1.8)	(1.9)	(4.7)
Total	$20.9	$ 9.4	$ 5.8	$28.9	$27.1	$23.5

*1985 data include transactions completed as of Jan. 10, 1986, the effective date of the Federal Reserve Board ruling on junk bond use.

**1986 data include transactions completed between Jan. 11, 1986, and Sept. 30, 1986.

SOURCES: Noninvestment Grade Debt as a Source of Tender Offer Financing, Securities and Exchange Commission, Washington, D.C., June 20, 1986; SEC 14D filings; IRRC company surveys.

grew to nearly 16 percent in 1985 and to 29 percent for the first nine months of 1986. Bank borrowing declined from 72 percent of tender offer financing in 1985 to 59 percent in the first nine months of 1986, and the use of internal funds fell slightly as well. Equity issues grew somewhat from 1985 to 1986, from about 2 percent to about 5 percent.

At first glance, it would appear that the Fed ruling has had little or no impact on the use of junk bonds. If the ruling had any teeth, the data would have shown a decline in the use of junk bonds. But the information presented in the chart shows an increase in the use of debt issues since the ruling. This analysis therefore appears to confirm the opinion of Wall Street experts that the Fed ruling has had little or no impact on the use of junk bonds in takeover financing.

However, in a second analysis, IRRC examined the use of junk bonds in somewhat more detail. This analysis covers junk bonds used to finance tender offers over the period July 1, 1985, to Sept. 30, 1986. The analysis includes the same tender offers as above, but in this case debt issues are split into two categories--investment grade and non-investment grade debt (as defined by Standard and Poor's). While the time frame is rather short, the extra level of detail provides more insight into the impact of the Fed ruling.

IRRC's second analysis suggests that the Fed ruling has had a slight negative impact on the use of junk bonds in tender offer financing. During the second half of 1985, before the Fed ruling came into effect, junk bonds represented 11.1 percent of tender offer financing. For the first nine months of 1986, after the ruling became effective, the use of junk bonds fell to 7.6 percent of tender offer financing. Presumably, if the Fed ruling had not been in place, the amount of junk bonds used in tender offer financing would have continued on its upward trend from 1985. Therefore, the Fed ruling appears to have reduced the use of junk bonds as the initial financing source for tender offers in 1986.

Investment-grade debt represented 4.8 percent of tender offer financing for the second half of 1985 and 21.4 percent of tender offer financing for the first nine months of 1986. These data confirm the opinions of takeover experts, who have told IRRC that the Fed ruling has encouraged more acquiring companies to issue debt themselves, rather than issue junk bonds through a shell corporation. The increase in equity issues also appears to confirm the opinion of Wall Street experts that some acquiring firms are using preferred stock as an alternative to junk bond financing.

Finally, although the amount of bank borrowing in 1986 appears to have fallen off from previous years, industry experts say there is more there than meets the eye. A Drexel spokesman told IRRC that many acquiring companies that use bank loans as the initial financing source for tender offers refinance with junk bonds after the takeover is completed. This enables acquiring companies to comply with the Fed ruling while still relying on junk bonds for permanent takeover financing. IRRC was not able to verify the amount of junk bond refinancing in its company surveys.

Congressional Research Service Report

In December 1986, the U.S. House of Representatives Committee on Energy and Commerce released a report on the junk bond market prepared by Carolyn Kay Brancato for the Congressional Research Service. The report provides more estimates of the role of junk bonds in takeover financing before and after the Fed ruling. It is important to note that IRRC's survey covered the role of junk bond financing in tender offers, which are one form of takeover transactions. The CRS report provides estimates of the role of junk bond financing for all merger activity, including tender offers and leveraged buyouts.

The report estimates that junk bond financing accounted for approximately 3.3 percent of merger and acquisition financing in 1984, 4.5 percent in 1985, and 25.2 percent in 1986 (Jan. 1 to Aug. 15). Again, the CRS figures are not directly comparable to the IRRC survey because CRS included leveraged buyouts in its report, while IRRC covered tender offers only.

With respect to the impact of the Fed ruling, the CRS report concludes: "Whether or not the Federal Reserve ruling has slowed high yield bond financed takeovers is debatable....There appear to be somewhat fewer of the large, hostile high yield financed deals which catapulted high yield financing into public view during 1985....Or, it is entirely possible that...the financiers may have altered their tactics so as to be less visible to the financial press."

V. CONCLUSION

Junk bonds have been the subject of much criticism in the financial media. Many claim that they exacerbate an already serious problem--hostile takeovers--by providing corporate raiders an unfair advantage in the takeover game. However, data collected by IRRC show that the use of junk bonds in takeover financing has been much lower than is generally believed. At their peak, in the last six months of 1985, junk bonds represented only 11.1 percent of tender offer financing; that figure fell to 7.6 percent for the first nine months of 1986, probably as a result of the Fed ruling. The use of junk bonds might have been higher without the ruling, but probably not much higher, since the ruling applies to only a few situations.

As a result of the Fed ruling, more acquiring companies have been issuing investment-grade debt and preferred stock themselves, rather than issuing junk bonds through a shell corporation to finance takeovers. In addition, more acquiring companies that use bank loans as the initial financing source for tender offers are refinancing in the junk bond market as a way to circumvent the Fed ruling. In this sense, the ruling appears to have altered the timing of junk bond issuance more than the absloute amount of junk bonds issued to finance takeovers.

New Safety Concerns

Attention is now turning to the safety of investing in junk bonds, and there may be more basis for this concern than for concerns over the use of junk bonds to finance takeovers. Although the risk-reward ratio of junk bonds has been very favorable to investors over the last few years, the default rate of the bonds accelerated significantly in 1986. The bankruptcy of LTV in July, for example, shook the junk bond market by putting nearly $375 million of LTV notes, already rated below investment grade, into default status. Other notable defaults in recent years include Storage Technology, Pizza Time Theater, Amarex, Damson Oil, Nucorp Energy, Global Marine, Savin and Crystal Oil.

Louis Lowenstein, professor of law at Columbia University, is among those who worry that in the next economic downturn, the default rate of junk bonds is likely to reach dangerous levels. He is especially concerned about the ramifications of large defaults in the savings and loan and pension fund industries, both of which have become large investors in the junk bond market.

In an Aug. 24 op-ed piece for The New York Times, Lowenstein wrote that "a substantial portion of these bonds has been purchased by struggling savings and loan companies willing to make a desperate, all-or-nothing bet — if the junk bonds pay off, the institutions survive; if they default, the savings and loans fail." For example, The Wall Street Journal reported that Columbia Savings and Loan Association of Beverly Hills, Calif., had invested 28 percent of its assets in junk bonds as of June 30, 1986.

Lowenstein noted that although the Federal Home Loan Bank Board was moving to restrict such high levels of investment, if any S&Ls did fail because of defaults in their junk bond portfolios, it is the taxpayers who would wind up footing the bill because government insurance would be used to pay off depositors.

Lowenstein told IRRC he was even more concerned about the "potentially explosive problem in the pension industry." He said an increasing number of companies are terminating overfunded pension plans and replacing them with single-payment annuities purchased from insurance companies that can offer the best price. As he wrote in The New York Times, "Of course, the companies that offer the best prices are those that have invested heavily in high yield bonds. The risk of default on these annuity contracts may come from both ends of the investment spectrum. The least profitable junk bond issuers, being most vulnerable to an economic chill, may default on their obligations, and those that are most profitable will try to redeem their high coupon bonds and replace them with new securities with lower yields [few junk bonds are issued with call protection]. An insurance company relying on junk bonds to sustain higher than ordinary levels of income might, therefore, see its income sharply reduced in both cases." The danger to pensioners is that once a company terminates a plan and replaces it with an annuity, its obligation to the pensioner is over.

Other experts in the field agree that dangers exist, but see the problem more in terms of the rising level of debt overall in the U.S. economy. Lawrence Chimerine, chairman of Chase Econometrics, told IRRC "the problem is not just junk bonds, although they certainly add to the problem. The danger is the enormous amount of debt at all levels in the economy, and the danger that companies will not be able to meet their debt obligations when cash flows are squeezed in the next economic downturn." He said junk bonds exacerbate the problem because they require higher cash payments than investment grade debt.

In his article, Lowenstein criticized the SEC for not taking into account the danger of large defaults in its study of the junk bond market. He told IRRC the federal government needs to consider seriously its policy toward the junk bond market before the next severe economic downturn. Because of the high stakes involved, he said that in addition to the SEC, the Federal Home Loan Bank Board, the Department of Labor and the Pension Benefit Guaranty Corporation all should consider how to handle the growing threat of massive defaults in the junk bond market.

A spokesman for the Federal Home Loan Bank Board, the federal agency that regulates the savings and loan industry, told IRRC the board is "studying the issue of whether junk bonds have caused any problems in the thrift industry and what the Bank Board should be doing about it. No decisions have been made yet." He added that probably no decisions would be made for a while because the board has several new members who will need time to learn about the issues.

Similarly, Gloria Della of the Labor Department's Pension and Welfare Benefits Administration (PWBA) told IRRC that "PWBA doesn't have guidelines on exactly what pension funds can or can't invest in; we just have general fiduciary guidelines."

Joseph Coyne, a spokesman for the Federal Reserve Board in Washington, told IRRC the Fed has not concerned itself with the junk bond market since the rulemaking in December 1985, and has not developed a new policy, mainly because it has not been asked to consider the issue again.

Marshall Blume, professor of finance at the Wharton School, told IRRC that although the default rate for junk bonds increased in 1986, the securities "still deserve a place in a well-diversified portfolio." He noted, "It's clear that if you put all your money in one place, whether it's junk bonds or other investments, you're taking a big risk." Asked about the dangers of savings and loans investing heavily in junk bonds, Blume said, "It's really only a few S&Ls on the West Coast that have invested heavily in junk bonds." He thinks these thrifts could be in trouble if junk bond defaults accelerate, but that as long as a portfolio is well diversified, most junk bond investors will continue to earn excess returns relative to their level of risk exposure.

Fallout from the Boesky Scandal

Concern over the safety of the junk bond market has risen dramatically amid widespread speculation that Drexel Burham Lambert and its junk bond guru, Michael Milken, could be implicated in the Ivan Boesky insider trading scandal.

In November, the SEC and the U.S. Attorney's office in New York issued subpoenas to top Drexel officers to investigate charges that Drexel leaked information to takeover speculators such as Boesky during the course of takeovers financed by Drexel. One possibility reportedly being investigated is that Drexel tipped off investment fund managers to upcoming takeover deals in order to persuade them to invest in junk bonds issued by Drexel. As of Jan. 1, neither Drexel nor any of its top officers had been formally charged with any wrongdoing, but the implications for the junk bond market could be serious.

In the days immediately following the announcement of the Boesky scandal and the investigation of Drexel, both the stock market and the bond market went into a tailspin. Takeover stocks were hit especially hard; Gillette, for example, the target of a takeover bid by the Revlon Group, declined nearly 12 percent in the first two days following the announcement of the investigation. Some long-term junk bonds fell 3 1/2 points over the same period (one point equals $10 for every $1,000 face amount of bonds). Treasury bonds fell as well, but not as much as junk bonds. Lipper Analytical Services reported that the prices of 52 junk bond mutual funds declined an average 1.22 percent between Nov. 13 and Nov. 26. During the same period, according to Lipper, fixed income funds of all types rose an average 0.45 percent.

Other immediate reactions to the Drexel investigation included the cancellation of several takeover attempts. Sir James Goldsmith accepted what many regarded as a greenmail payment from Goodyear, claiming the Boesky scandal had led to an "environment that isn't conducive to a takeover bid." Wickes Cos. announced Nov. 18 that it might not be able to arrange financing for its planned acquisition of Lear Siegler in light of the Drexel investigation. Wickes had been one of Drexel's largest junk bond issuers.

The stock and bond markets have since recovered from the initial shock, but concerns remain on Wall Street. The final outcome depends on whether Drexel, and Milken in particular, are formally charged with violating insider trading rules, and if so, what penalties they will face. In the best-case scenario, Drexel and Milken would be cleared of any wrongdoing, and the junk bond market could return to normal. However, many are concerned that even if Drexel is cleared of any wrongdoing, its business, and by implication the entire junk bond market, will experience an unavoidable contraction. As Tim Carrington wrote in The Wall Street Journal: "In the end, the firm [Drexel] and its officers may be found free of any taint in the Boesky insider trading scandal. However, in the securities business, even a temporary dent in a company's reputation can translate quickly into losses."

In the worst-case scenario--both Milken and Drexel being convicted of misconduct in the Boesky affair--one of two things could happen, according to Wall Street experts: Either other firms will step in to pick up Drexel's junk bond operations, or the entire market will contract because nobody can fill Drexel's shoes.

The major uncertainty surrounds Milken's precise role in the junk bond market. The concern is that if he has to leave the business because of insider trading charges, nobody else at Drexel or on Wall Street in general will be able to sustain a secondary market as well as he has. Unlike investment grade bonds, which are supported by a global institutional trading network, the junk bond market is basically sustained by Milken and Drexel. Milken, not a Quotron terminal, provides the quote to an investor who wishes to sell junk securities. Milken in turn can quickly resell the securities through Drexel's network of junk bond investors. If no one else can duplicate Milken's role in the secondary market, the original-issue junk bond business will deteriorate as well. Investors would be reluctant to purchase an original-issue junk bond if they were not assured by Milken's presence that they could sell the securities with ease. According to Talton Embry, president of Magten Asset Management, "It wouldn't be a vacuum that could be filled. It would be a diminution of the business. Milken—it's him."

The opposing view is that other Wall Street firms would step into Drexel's shoes if Milken is charged with insider trading violations. In this case, the change would be a shift in market share rather than a contraction of the junk bond market. Merrill Lynch, Goldman Sachs, First Boston, Morgan Stanley and Kidder Peabody are among the firms most frequently mentioned as eager to move into Drexel's junk bond business.

It is also possible that the junk bond market could be subject to new federal regulation as a result of the Boesky scandal and the investigation of Drexel. On the one hand, the Boesky scandal and Democratic control of the U.S. Senate in 1987 could strengthen the hand of those opposed to junk bonds. Two key Senate Democrats—William Proxmire of Wisconsin and Howard M. Metzenbaum of Ohio—already have announced that they will hold hearings on insider trading and hostile takeovers. Proxmire will chair the Senate Banking Committee in the new Congress; Metzenbaum will head the Antitrust Subcommittee of the Judiciary Committee.

On the other hand, the Reagan administration and other free market proponents insist that the insider trading case should not be used to curtail takeover activity, which they view as beneficial. These sentiments were best expressed by T. Boone Pickens Jr., head of Mesa Petroleum, who told the New Republic: "Using the Boesky affair as a reason to stop takeovers is like using the arrest of a bank robber to shut down the banks."

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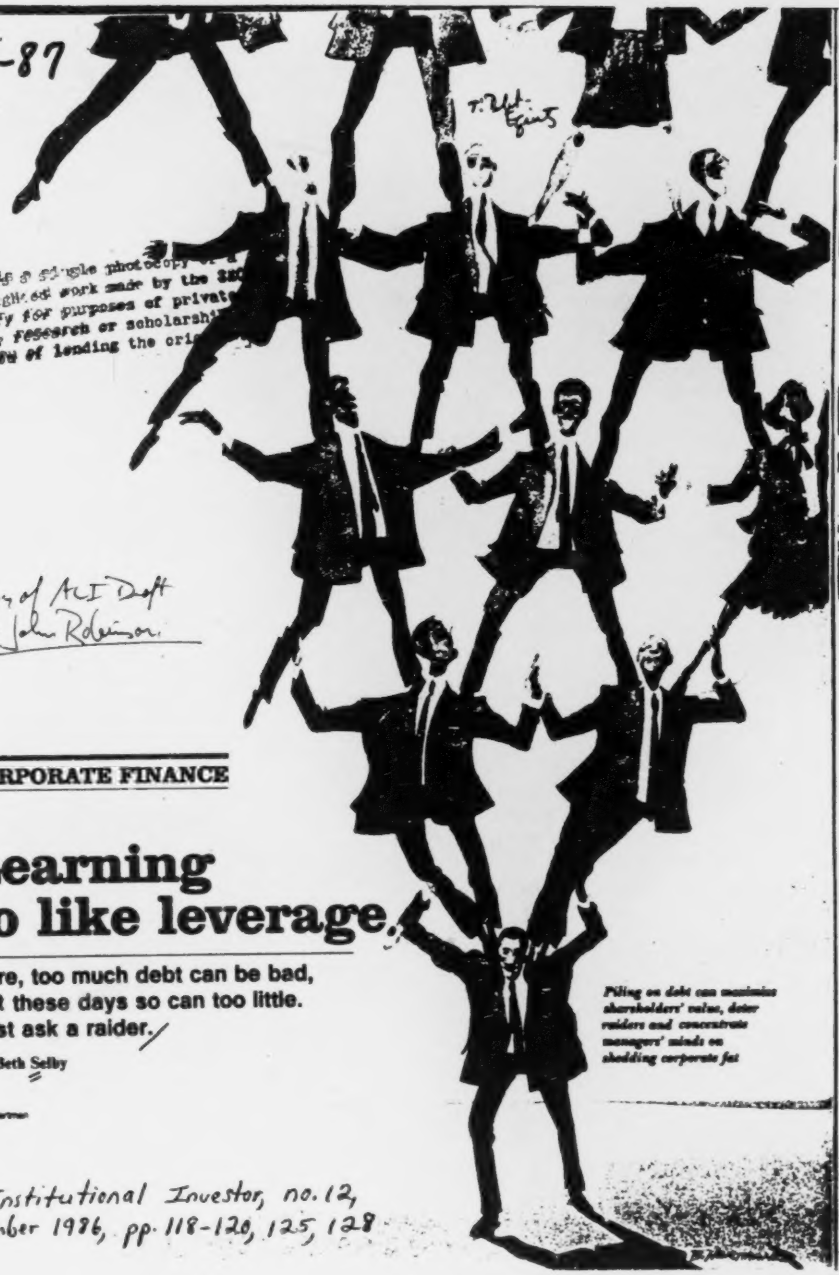

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CORPORATE FINANCE

Learning to like leverage

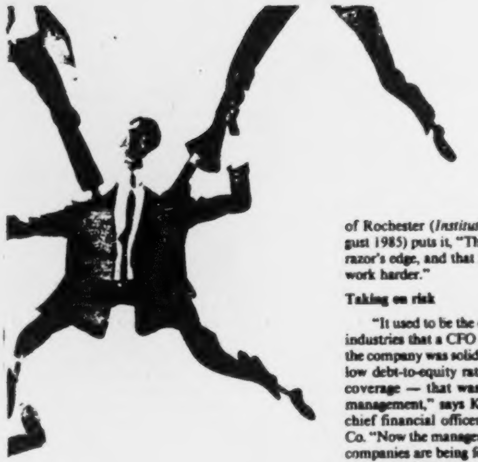
Sure, too much debt can be bad, but these days so can too little. Just ask a raider.

by Beth Selby

Piling on debt can maximize shareholders' value, deter raiders and concentrate managers' minds on shedding corporate fat

Bill Hartman

20 Institutional Investor, no. 12,
December 1986, pp. 118-120, 125, 128



"There shouldn't be any triple-A corporates. A company that's got a triple-A rating is not using its resources to its own best advantage."

Once such a pronouncement coming — as it in fact does — from the head of bond research at a bulge-bracket firm would have been regarded as rank heresy. Today it represents the emerging conventional wisdom. For perfectly sound reasons in most cases, companies have become increasingly fond of debt as a multipurpose financial tool, in the process flouting traditional creditworthiness benchmarks.

Just consider what heaping on extra debt — within reason — can accomplish, quite apart from the traditional functions of sustaining operations and underwriting new projects. It can give a boost to return on equity and thereby help maximize that all-important shareholders' *value*. Partly for this reason, a strategic piling on of debt, particularly for a stock buyback, can also deter corporate raiders on the prowl for undervalued assets. What's more, the prospect of sizable debt payments seems to have a marvelous capacity to concentrate managers' minds on shedding corporate fat that soaks up cash flow. As outspoken academic economist Michael Jensen of Harvard University and the University of Rochester (*Institutional Investor*, August 1985) puts it, "They are walking on a razor's edge, and that means they have to work harder."

Taking on risk

"It used to be the case in a lot of older industries that a CFO was doing his job if the company was solidly capitalized, had a low debt-to-equity ratio and a high fixed coverage — that was prudent financial management," says Kenneth Yarnell Jr., chief financial officer of American Can Co. "Now the managements of these same companies are being forced to think more in terms of [return on equity]. And one way to improve ROE is to take on more financial risk." That is, debt. Philip Morris CFO Hans Storr explains what the new order of things means for his company: "To do better than the single-A rating we have right now, we would have to bring our debt-to-equity ratio down from about 1.25 to 0.50, and at that point the company would be underleveraged and I wouldn't be doing my job."

To be sure, if underleverage is bad, overleverage is far worse, and CFOs' new infatuation with debt-skewed balance sheets is by no means an unalloyed boon for them or the economy. Indisputably, the amount of debt corporations have taken on, for whatever reasons — sound or otherwise — since 1982 is staggering. Ordinarily, this late in an economic recovery most companies would be cutting back their borrowing and shoring up their balance sheets for the inevitable downturn. And companies did issue $41 billion of stock in the first three quarters of this year. But in the same nine months they also raised a net $81 billion of new debt in the public markets. And an ever larger portion of this debt was below investment grade; more than one fifth of bonds outstanding now qualify as high yield, compared with less than 10 percent a decade ago.

Industrial companies' average debt-to-net-worth ratio, meanwhile, has climbed steadily over the past couple of decades to an eye-popping 118 percent from around 70 percent in 1966, according to figures compiled by Shearson Lehman Brothers economist Allen Sinai; since just 1984 the ratio has risen by roughly one quarter. Credit ratings reflect this: A paltry 26 companies are currently entitled to call themselves triple-A, less than half the number of a decade ago; and in the 1978–1984 period, credit downgradings exceeded upgradings by 218.

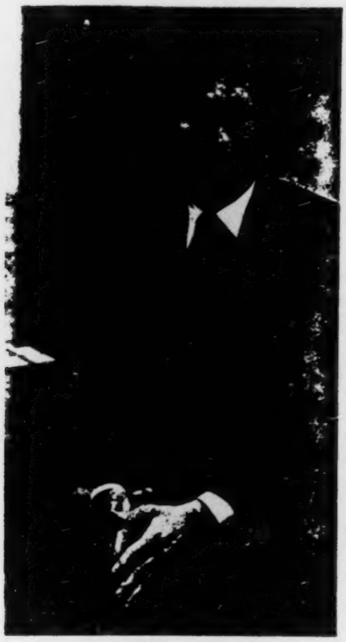
Critics are right to be concerned with the overall trend, particularly since mounting corporate debt has been matched, and overmatched, by soaring government and consumer debt. Leverage may work miracles for profit and loss statements in good times, but it can cause mayhem in bad times, of course, since it exaggerates the effect of economic cycles.

Many companies, particularly some of the more hyperleveraged megabuyouts, are undoubtedly teetering on the cliff's edge (*Institutional Investor*, November 1986). Yet many other corporations have managed to take greater advantage of leverage in recent years without putting themselves in so precarious a position.

The singular virtues of leverage, of course, have long been appreciated by many CFOs. Simply stated, since interest payments can be deducted from corporate income taxes and dividends can't (and, in fact, get taxed twice, at the corporate and the investor levels), the cost of debt capital is generally cheaper than that of equity capital. The key exception: when high price-earnings ratios make it more attractive for companies to issue shares than bonds. Even with tax reform's lowering of the top corporate income tax rate from 46 percent to 34 percent, debt still has a decided edge over equity.

More to the point, by leveraging up its assets, a company can also jack up its return on equity. As its profits grow from investing the debt (often in an acquisition), the returns get distributed over a share base that is proportionately smaller vis-à-vis the company's total capital. Result: fatter dividends and a higher, perhaps even raider-proof, share price. Stock buybacks accomplish the same end, of course, which helps to explain their recent popularity.

Textron CFO Dennis Little delivers an unblushing testimonial to the power of leverage. Since buying Avco and Ex-CellO in recent years, the aerospace and



American Can's Yarnell: "Managements are being forced to think more in terms of [return on equity]. And one way to improve ROE is to take on more financial risk"

technology company's debt-to-total-capital ratio has shot from 14 percent to close to 60 percent because of the takeover debt. But at the same time, gloats Little, "our ROE has gone from 9 to 15 percent."

All this, as New York University business school dean Richard West points out, is no more than "basic corporate finance." The so-called Modigliani-Miller theory, for instance, takes into account debt's tax advantage, assumes zero bankruptcy costs and argues, essentially, that companies should theoretically borrow as much as they can up to the point of soaking up all their taxable income (to maximize the tax advantage) before they resort to issuing so much as a single extra share of equity. Two obvious checks on this strategy are the risk of pushing debt so far as to court bankruptcy and the CFO's own comfort level for tolerating debt.

Sea change

What is *new* today is not the intellectual underpinning for making liberal use of leverage but the economic circumstances that make the case for doing so suddenly much more compelling. As NYU's West, a specialist in corporate finance, puts it: "It's not that the people have gotten smarter. The environment has changed."

A host of factors accounts for this sea change. Lower interest rates and abundant investment capital now encourage borrowing. Improved but still relatively low P/E ratios, meanwhile, discourage issuing shares (for most established companies, at any rate). Ever-more-dominant institutional shareholders are increasingly able to translate their fixation on short-term performance into pressure on companies to resort to sundry financial ploys — including leverage — to sustain steady earnings. The copious cash flows of many mature industrial companies — basically, Rust Belt cash cows — allow them to take on lots of debt in the process of restructuring themselves for the "post-industrial" economy. And financial innovations that permit active liability management, such as interest rate swaps, allow savvy CFOs to minimize some of the risks of carrying heavy debt loads.

But at least as much of a factor in making additional debt more acceptable as all of the above is the merger phenomenon. In a sense, corporate raiders have served as self-appointed (and well-recompensed) financial consultants who've conducted clinics for CFOs and CEOs on the benefits of leverage — and the potential perils of having *too* pristine a balance sheet. The raiders' great insight, of course, was that the stock market had undervalued many companies' assets and that the way to unlock these hidden values was to apply leverage. By brazenly pledging target companies' assets as collateral, raiders have been able to borrow the funds to pull off actual takeovers or, more often, amass a sufficient number of shares to pose a credible threat and exact a tribute of greenmail.

LBOs, meanwhile, have introduced a whole new notion of the permissible limits of leverage. Though buyouts have been around since at least the 1930s, when Union Securities was taken private, there are far more of them today and they are much, much bigger. Kohlberg Kravis Roberts & Co.'s management buyout of Beatrice Cos. last year amounted alone to $6.2 billion. In the typical megabuyout, some 90 percent of the capital is debt (84 percent in Beatrice's case, based on pro forma financial figures), and *more* than 100 percent of the cash flow can be committed to debt payments (that is, the LBO must sell assets to meet its obligations).

To the surprise of many observers and perhaps some participants as well, scores of the buyouts of recent years have not, in fact, gone bankrupt — yet. Even so, LBOs have so far been tested under only optimum laboratory conditions. "We haven't seen how these LBOs will fare in a recession," notes American Airlines CFO John Pope. Depending on how buyouts do under such duress, the current vogue for leverage will either get a boost or suffer a setback.

Tacit allies

Impatient institutional shareholders, of course, are the raiders' tacit allies in promoting leverage. They are willing to accept — indeed, now demand — that companies make expeditious use of debt to bolster their returns.

Of course, the more leveraged a company is, the more of a premium it must pay to attract funds, which benefits institutional investors willing to buy bonds of

NYU's West: "It's not that the people have gotten smarter. The environment has changed"

Giorgio Palmisano

less than top-rated borrowers. "I do not have a problem with a highly leveraged piece of paper, if there's a high enough yield attached to compensate me for that risk," says one major fixed-income investor. That's especially so, he adds, since highly leveraged corporations today have a greater ability to create cash by selling off assets and manipulating the business to reduce debt levels.

Managing the books

The quickest and surest way for corporations to accommodate shareholders' performance myopia is to engage in active financial management. "The [management] mentality has changed from operations to the business of financial manipulation because of the short-term view of stockholders — and that's changed management's perspective on debt," contends one well-respected CFO. Or, as Prudential-Bache Securities economist Edward Yardeni candidly puts it, for better or worse, "companies are managing their books rather than their businesses."

Colt Industries exemplifies one extreme of the current thinking. The old-line manufacturer, whose diverse operations encompass major aerospace, automotive and industrial divisions, embarked last fall on a highly leveraged recapitalization plan. The immediate effect was to render Colt's financial position technically one of *negative* net worth, at least temporarily; the company's pro forma balance sheet as of June 29 showed a total debt position of $1.42 billion and shareholders' equity of *minus* $1.56 billion.

The reason for this anomaly: Colt bought back an enormous chunk of its own shares at a premium over their market price and then duly subtracted the shares' combined value from its existing shareholders' equity — which, of course, reflects only the stocks' *original* price — with the result that, technically anyhow, the company succeeded in wiping out its entire equity base. (Because no takeover was involved, Colt could not avail itself of purchase accounting to revalue the remaining equity.) At the time, Colt's true financials were, in fact, more like debt of $350 million, shareholders' equity of $447 million. As Colt CFO Salvatore Cozzolino says of the leveraging gambit, "Lenders and shareholders are accustomed to a lot more leverage today — it's not a dirty word anymore."

This is taking balance sheet engineering pretty far. But too far? Assuming that the old leverage ratios are becoming obsolete, what are the new benchmarks for aggressive — but also prudent — debt management?

The not entirely satisfactory answer: It's hard to say. Morgan Stanley & Co. managing director John Wadsworth explains the problem: "For a high-tech or early-stage company, 100 percent equity is proper. At the other end of the spectrum, for a classic, proven company with twenty or 30 years of operating history, a stable position in the marketplace and strong, steady cash flows — like some heartland manufacturers — 90 percent debt may not be a problem. But between the two ends of the spectrum, it's a gray area."

Shearson Lehman's Sinai: "Is the manufacturing sector of our economy slowly liquidating itself?"

Emerging spectrum

Still, some broad standards have begun to emerge for industry groups. Clearly, mature companies that are cash-rich and can count on reliable cash flows, such as broadcasters, utilities and retailers, can abide fairly hefty leverage. By contrast, even well-established companies in relatively young and volatile high-growth industries, such as computers, are generally well advised to shun high debt levels.

Mighty IBM ventured into the debt market for the first time as recently as 1979, and rival Hewlett-Packard Co. has yet to issue a single bond. Apple Computer isn't averse to tinkering with its balance sheet to bolster return on equity, as the company's current stock-buyback program attests. But Apple is paying cash for the stock (7 percent of its 64 million shares outstanding) and has no intention of making its debut in the debt markets anytime soon, declares CFO David Barram firmly.

But even among high-tech companies, the debt question is not all that clear-cut. To some extent, it comes down to the CFO's call. For instance, Lotus Development Corp., maker of the familiar 1-2-3 spreadsheet software, has undertaken a second stock buyback and, in what NYU's West terms the "ultimate leverage play," has borrowed $30 million to pay for the shares. The result has been a radical rejiggering of Lotus's balance sheet worthy of a 1-2-3 demonstration. From $138.5 million of equity and zero debt, the company will go to approximately $82 million of equity and $30 million of debt, if and when the second buyback is completed. In the process Lotus expects to deplete its cash on hand by 50 percent to pay for the first buyback and part of the second.

"We had more cash on hand than we needed for research and development and acquisitions," explains Robert Langer, Lotus vice president for finance. Smith Barney, Harris Upham analyst David Readerman calculates that the combination of the buybacks and borrowing should boost Lotus's return on equity from 28 percent at the end of 1985 to some 44 to 48 percent. Langer says he's quite comfortable with the debt, since Lotus's business is quite stable, despite the volatility within its industry.

Buybacks have been realigning more than just computer companies' financial statements, of course. Irving Leveson, senior vice president of the Hudson Strategy Group, reckons that repurchase programs and acquisitions together will have retired $220 billion of equity from companies' balance sheets between the beginning of 1984 and the end of this year. This represents a massive indirect leveraging of corporate America. "One phenomenon in corporate finance today is the aggressive management of equity," notes First Boston corporate finance chief Richard Bott. "In the past, there was always a price at which a company would sell stock, but over the years the attitude has grown that there is a price at which a company will sell stock and a price at which it will buy stock. There is no permanence in the equity of a company."

Two-pronged action

One reason companies can get away with jacking up their leverage by managing their equity is that they are simultaneously managing their debt. The current, prolonged economic recovery has defied conventional patterns and forced companies to modify their borrowing practices accordingly. Just to survive the deep 1981 recession, many companies borrowed heavily. Then, once the recovery was well under way, they saw their profits eroded by a stubbornly high dollar that hampered their exports and pushed the U.S. trade deficit to record levels. "Companies got hit with this triple whammy, forcing them to borrow more now," notes the Hudson Strategy Group's Leveson.

Moreover, the business and monetary cycles have been strangely out of sync. "By the end of the second year [of the recovery], I was trying to convince every CFO I talked to to start funding out short paper and go long," recalls Morgan Stanley economist Stephen Roach ruefully. "Nobody would listen to me, but it turns out they were right." Interest rates kept right on falling, and CFOs wisely clustered their borrowing at the near end of the conspicuously positive yield curve.

That go-short strategy has now become more or less institutionalized, suggests Leo O'Neill, head of debt ratings for Standard & Poor's Corp. The ratio of short-term to long-term debt hit a post-World War II high of 51.5 percent in 1985. As a result, many CFOs seem to be much more concerned with maintaining their commercial paper ratings than their long-bond ratings, and so take pains to ensure that their cash and cash equivalents are ample to cover their near-term liabilities. "Just look at the percentages," says O'Neill. "They are skewed to the upper end — 80 percent [of companies] are A-1, 18 percent A-2, and only a handful are A-3's."

Lately, as long rates have eased, companies have refinanced old, high-coupon debt — some $31.6 billion worth in the first nine months of this year. The effect has been to reduce the short-to-long debt ratio to a still historically steep 49 percent, according to Shearson Lehman's Sinai.

Much of this short, floating-rate debt, though, has been converted to fixed rate through swaps and hence poses less of a risk for companies during a recession. Textron's Little says that's the case with his company and, moreover, that he has the option to stretch out some of Textron's short funds — in the form of a revolver loan — several years.

None of this is to imply that the sky's the limit for corporate leverage nowadays. Companies so deeply in hock that virtually all their earnings go to service debt with nothing left over for reinvesting in operations — as is the case with some LBOs — are overleveraged by any reasonable measure. Playing the devil's advocate, Shearson Lehman's Sinai wonders, "Is the manufacturing sector of our economy slowly liquidating itself?"

Even CFOs who've made the most of leverage recognize its limits — especially at this late stage of a recovery. American's Pope has brought the airline's debt-equity ratio back from roughly 1.8 to 1 in 1982 to closer to 1 to 1. Chief executive James Cotting of Navistar International Corp., whose brush with bankruptcy when the old International Harvester did nothing to raise the ex-CFO's debt comfort level, has announced plans for an equity offering meant to slash Navistar's long-term debt from $736 million to $222 million and thus its debt-to-total-capital ratio from 88 percent to 27 percent. Even Little, who has used leverage to good advantage in improving Textron's ROE, now says he wants to work his company's debt-to-total-capital ratio back down from about 60 percent to closer to 40 percent.

"Some people have been lulled to sleep because of this long expansion, and I think there's a real risk in that," argues Pope. "Now's the time to clean up the balance sheet, because we're coming off the top of these good times." It's hard to quarrel with that advice. Yet "cleaning up the balance sheet" no longer requires quite the same exertions to dispose of "excess" leverage that it once might have. It may be stupid — and risky — nowadays to be overleveraged, but, as Pope also points out, "It's equally dumb to be at zero debt." ■

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From
THE NEW YORK TIMES, SUNDAY, NOVEMBER 24, 1985

Balance Sheets Aren't All That Weak

By ROBERT A. TAGGART Jr.

INCREASINGLY, we hear that United States corporations are sliding down a slippery slope of excessive reliance on shaky debt financing. This trend, it is argued, could lead to strings of bankruptcies in the event of a serious economic contraction.

Indeed, a variety of statistics appear to support these arguments. From the beginning of 1984 through the first quarter of 1985, debt financing provided 44 percent of total sources of funds for non-financial corporations. Even more ominous, critics say, short-term debt during this period accounted for 73 percent of net new liabilities.

The critics point further to a steady deterioration in traditional balance-sheet ratios during the postwar period. The Fortune 500 industrial companies, for example, had year-end total liabilities for 1984 equal to nearly 54 percent of total assets, a postwar high. For all non-financial corporations, short-term liabilities represented 32 percent of total debt at the end of the first quarter of 1985, again a postwar high, while corporations' cash on hand (the technical term is "liquidity ratios") simultaneously reached postwar lows.

To reverse this purported long-run trend toward shakier corporate balance sheets, many experts would roll back financial deregulation, making commercial lenders more conservative. Such actions would be premature. The figures that are causing so much consternation are misleading for several reasons.

First, the end of World War II is a useless reference point. By almost any measure, corporate leverage was unusually low at the end of the war. Corporate purchases of Treasury securities during the war also resulted in unusually high levels of liquidity. Thus, corporations emerged from the war years with such conservative financial positions that recent trends are bound to appear risky by comparison.

Second, traditional accounting methods are potentially misleading. During inflationary periods, accounting tends to overstate debt burdens and to understate the replacement value of corporate assets. Thus, we need a different measure than the traditional ratio of debt to a corporation's "book value," which understates the earning power of the assets and overstates debt burdens.

When the ratio of debt to total capitalization is estimated at market values, rather than book values, for all non-financial corporations, it comes to 26 percent in 1983 and 27 percent in 1984. These are the lowest levels since 1972, and contrast sharply with the postwar high of 38 percent, recorded in 1974.

Third, the undeniable increase in short-term debt is not so much a trend toward reckless financing as it is a rational response to the uncertainties of inflation. Interest rates on long-term debt are high now precisely because lenders fear a recurrence of inflation. Understandably, corporate treasurers are wary of locking in long-term debt at such high rates — it could be injurious if the inflation rate stayed low. Thus, short-term borrowing made more sense in the last few years.

ACTUALLY, as the most reliable data make clear, corporations have undertaken considerable balance-sheet rebuilding in the past decade after relying heavily on debt during the period of 1965 to 1974. These rebuilding efforts are particularly evident in corporations' increased reliance on internally generated funds (retained earnings plus depreciation). Very recently, many corporations have also tried to reduce their short-term debt proportions. As long-term interest rates have declined, bond financing has once again become attractive, and the preliminary indications are that 1985 will be a record year for corporate bond issues.

Unquestionably, corporations did rely heavily on debt in 1984 and early 1985 but this reflects an unusual and temporary burst of retirements of corporate stock. These retirements were so large that net corporate stock issues were actually a *negative* 17 percent last year. This means that stock issues subtracted 17 percent from the total sources of corporate financing.

To a considerable extent, the heavy stock retirements reflect the wave of restructuring that has swept across the corporate landscape. Some of the stock has disappeared as publicly held corporations have gone private through leveraged buyouts. Other corporations, while remaining in public hands, have returned large amounts of funds to their shareholders through stock repurchases.

This restructuring should not be interpreted as a long-run trend toward greater corporate leverage. The phenomenon is too recent to be called a trend. Much of the debt issued for leveraged buyouts and stock repurchases will be paid back as cash flows accumulate, restoring debt ratios to more traditional levels. And, as we have seen above, the evidence supporting any long-run trend toward greater leverage is dubious.

In sum, there is little reason to believe that the financial strength of the corporate sector has eroded dramatically in recent years. Those who would use the issue of corporate indebtedness to urge tighter regulatory control over commercial banks or limits on the use of debt financing in acquisitions to curb perceived financial excesses in the corporate sector are crying wolf. Banking regulation and mergers are indeed important public policy issues. Debate over these, however, should not be clouded by exaggerated fears. ■

Robert A. Taggart Jr. is professor of finance at Boston University.

A Study

by

The Office of the Chief Economist
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

September 25, 1985

Motivations for Hostile Tender Offers and the Market for Political Exchange

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The views expressed herein are those of the Office of the Chief Economist only. The Commission has expressed no view on this study.

MOTIVATIONS FOR HOSTILE TENDER OFFERS AND THE MARKET FOR POLITICAL EXCHANGE

Annette B. Poulsen

and

Gregg A. Jarrell*

This paper reviews the arguments concerning the role of hostile tender offers in today's corporate world. Some observers suggest that "corporate raiders" do not pay shareholders a fair price for their holdings and disrupt day-to-day operations of firms. Others point to the significant premiums paid to shareholders in tender offers and suggest that raiders play an important role in forcing change in corporations. We also consider proposed regulation in the corporate control area and present our views on the viability of these regulations.

In 1984, 82 firms worth more than $43 billion were successfully taken over via a tender offer. Through the first six months of 1985, tender offers valued at over $25 billion have been initiated. Some of the very largest firms in the country have been the targets of these offers, and many of these offers have involved prolonged and bitter fights between the bidder and target. Given the magnitudes of these figures, it is not surprising that this multibillion-dollar market for corporate control is at the center of an economic and political debate.

By some standards, total merger and acquisition activity has not increased dramatically in recent years. The number of reported transactions each year in the 1980s (slightly more than 2000) does not approach the number of transactions observed annually from 1967 through 1974 (ranging from almost 3000 to more than 6000). However, the total value of mergers and acquisitions is at record levels -- in nominal terms, the average annual reported value of mergers and acquisitions from 1981 through 1984 is approximately 48% larger than in any four-year period in the late 1960s and early 1970s (Council of Economic Advisors (CEA), 1985, pp. 192-193). Total mergers and acquisitions from 1981 through 1984 were valued at $347 billion in 1983 dollars.

Tender offers represent only a small proportion of total merger and acquisition activity; successful offers number fewer than 100 each year in the 1980s. Only about half of all successful tender offers are hostile (Office of the Chief Economist (OCE), 1985a). However, these hostile tender offers have generated the current furor in Congress and the press. Targets of recent hostile tender offers have often been billion-dollar, well-known firms -- firms such as Unocal, Phillips Petroleum, CBS, and American Natural Resources. Tactics used by both bidders and targets outrage the casual observer -- "greenmail," "poison pills," "shark repellents," and old-fashioned, mud-slinging litigation dominate press accounts of the contests.[1] Congressional hearings on tender offers and tactics of this rich man's game seem to occur every month. Those who carry out hostile tender offers are known as "raiders" -- a term we will use in this paper despite its pejorative nature.

The most important factor in explaining the increased concern over hostile tender offers is the prevalence of billion-dollar firms in the game. No longer protected by an "anti-big" antitrust policy and faced with increasingly impotent state protection, managers of large corporations are turning to the political marketplace at the Federal level for protection.[2] Business associations, such as the Business Roundtable and the National Association of Manufacturers, and individual corporations have taken a very active role in this political debate. Requested protection has taken several forms -- moratoriums on tender offers in specific industries, restrictions on investor activity once a certain threshold of ownership is reached, restrictions on certain types of financing, and restrictions on targeted share repurchases, to list a few.

An economic theory of tender offers helps in understanding the political exchange. In general, the political debate centers on hostile tender offers; mutually agreeable acquisitions are far less controversial. Both proponents and opponents of hostile tender offers have established theoretical underpinnings to their arguments concerning the impact of potential and actual corporate control battles. In this paper, we review the alternative economic rationalizations and contrast their respective implications with the growing body of empirical evidence behind these positions. We then turn to some of the details of the political debate and provide some of our thoughts on how the debate will be resolved.

I. The Battle Over Corporate Control

The appropriate role of corporate raiders in today's business world is extremely controversial. In this section of the paper, we review some of the most frequently made arguments concerning raiders. In section II, we evaluate the evidence for support or refutation of these arguments. In general terms, those who suggest that raiders serve an important role in the economy see the raiders as a force for change in firms that could be run more efficiently. On the other hand, those who believe that raider activity must be limited argue that raiders have a substantial and harmful impact on the ability of present management to run the firm and at least implicitly believe that raiders on average cannot improve the operation of target companies.

A. Raiders as a Catalyst for Change

Proponents of hostile tender offers argue that control contests serve a valuable role in disciplining corporate management. The organization of any firm with more than several shareholders necessarily requires a separation of ownership and control. Berle and Means (1932) identified this phenomenon early and many researchers have studied its implications. (See, for example, Fama, 1980.) Shareholders select a management team to serve as their agents in determining the most profitable use of the firm's resources. The basic assumption of this group is that the price of shares in the firm at any given time is an unbiased indicator of the value of the firm's assets in their present and potential use under incumbent management.

Hostile tender offers are expected to occur in firms where there is a difference between the market's assessment of the value of the firm's assets under incumbent management and the raider's assessment of the value of those same assets under a different management team. This explanation is not based simply on the existence of poor or negligent management in the target firm. A new management group may be better able to adjust to changed factors in the economic environment, perhaps because it has specialized knowledge about or a willingness to adapt to those changes. Jarrell and Bradley (1980) suggest that corporate takeovers are a "by-product of innovative activity" -- bidders in takeovers have acquired new information about the use of the target firm's resources that leads them to expect to be more productive than incumbent management. They suggest that the most efficient way for innovators to implement their knowledge is through corporate takeovers.

The oil industry has recently been through dramatic changes and it seems no coincidence that in the past few years many hostile tender offers have occurred in firms in that industry. (For example, note the Unocal and Phillips Petroleum battles.) The recent slowing in price increases and the increasing costs for exploration and development imply that the optimal levels of reserves and capacity in the oil industry have fallen. In an industry long noted for its stability, these changes have forced managers to act in new ways and consider different alternatives. If incumbent managements do not or will not adjust voluntarily, potential or actual hostile tender offers may force these changes.[3]

Hostile tender offers also occur frequently in other industries where competitive pressures force firms to adapt to new market conditions. One-half of the total value of all mergers and acquisitions from 1981 through 1983 were in the petroleum, banking and finance, insurance, mining and minerals and food processing industries (CEA, 1985, p. 194). Many of these control changes are attributable to new opportunities created by large-scale deregulation in the finance and transportation industries and by increased import competition.

Easterbrook and Fischel (1982) suggest that these alternative managers should be treated as "patent holders" who have discovered important information about a target firm. In general, information takes on the characteristics of a public good, which once identified may be used by many. To ensure the efficient production of information, the bidder should be protected from other bidders benefiting from his discovery -- the quicker the original bidder is able to complete his transaction, and the less disclosure he is forced to make, the less likely an alternative bidder will be able to participate in an auction for the firm, forcing a higher premium to be paid. Thus, any gains from hostile tender offers should go to those who initiate the original bid. If this distribution changes, as it may when there is more opportunity for alternative bids, there will likely be fewer hostile tender offers made and thus fewer opportunities for wealth gains.[4]

Thus, hostile tender offers can serve as a catalyst for change in corporate management. Management changes could also occur through a friendly merger or acquisition or simply through the hiring of a new management team. However, mutually agreeable merger deals cannot always be arranged. Proxy contests calling for new directors are also relatively unsuccessful in replacing incumbent management.[5] In light of these considerations, the ability of alternative management teams to launch hostile offers is argued to be imperative to efficient operation of firms in the economy.

B. Raiders as Disruptive (and Destructive) Factors

Corporate managers and business groups argue that the activities of "raiders" disrupt the firm and that these activities should be limited. (For example, see Sigler, 1985). Though raiders may be able to identify firms where share prices are lower than they might be under alternative cirumstances, opponents of hostile tender offers suggest that any undervaluation of the firm is attributable incorrect valuation by the market. Thus, if a firm's assets could be better used, the raider should not appropriate the difference between the market value of the firm and its potential value if the market had all of the necessary information for correct valuation of the firm. Under this view, the managers of the firm (or their Wall Street consultants) know the firm's "true" value and fight hostile tender offers to protect shareholders from bidders who would "raid" the firm on the basis of more complete information than that of the market.

Incumbent managers also argue that raiders have a disruptive effect not only in the case of an actual hostile tender offer but also in the manner in which firms are run on a day-to-day basis. The potential presence of a raider may force managers to look over their shoulders and run the firm inefficiently. Many managers have argued that they are forced to emphasize earnings and short-run profits at the expense of long-run investment. Former SEC Commissioner A. A. Sommer, Jr., argues this point in stating "The ever lurking danger of a takeover distracts management from longer term considerations..., causing them instead to concentrate on a short-term performance record designed to raise stock prices to levels that hopefully might make the company a less tempting target." (1985, p. 8.) This viewpoint is further amplified in recent Wall Street Journal editorials and law journal articles.[6]

Opponents of hostile tender offers point to another potential cost imposed by raiders — that of disruption of corporate offices and local communities. In hostile offers such as those for Phillips Petroleum (by Mesa Partners) and Marathon Oil (by Mobil), "company towns" view themselves as victims of corporate maneuvering. If the hostile tender offers for these firms had been successful, corporate headquarters may have been moved and local communities left without an economic base. Some observers suggest a need for "community impact" statements before hostile tender offers are implemented to evaluate the total impact of proposed acquisitions on plant closings, layoffs and relocation of the firm's activities.

Concern is expressed not only about hostile tender offers but also about the tactics through which they are implemented. Two-tier tender offers are labeled as coercive because remaining shareholders after the initial bid for control is completed may be forced to accept a lower price for their shares than was paid for the controlling block or to accept payment in form of debt rather than cash. To avoid being a holder in this second tier of the offer, holders who may believe the offer to be too low may still tender into the first tier, thus ensuring the success of the offer. This phenomenon has been described as a prisoner's dilemma, in which all parties concerned might be better off if no one tendered but uncertainty about the actions of other holders results in acceptance of the offer (Bradley, 1980).

Recently, opponents of hostile tender offers have introduced concerns about the role of leverage and the use of "junk bonds" (non-investment-grade debt) in financing control contests. Testimony before Congress reviewed some of these issues. (For example, see Rohatyn, 1985). Though these opponents argue that non-investment-grade debt may have its place in corporate finance, they argue that it is totally inappropriate to use billions of dollars of high-risk debt to fund takeovers of large corporations. The remaining corporation after a successful takeover would be burdened with very high levels of debt service at relatively high interest rates. In addition to the cost to the firm itself, those concerned also suggest that the impact of a recession could be dramatically amplified by a large number of bankruptcies of highly leveraged firms and corresponding failures of banks and savings and loan associations holding the debt securities of bankrupt firms (Shad, 1984).[7]

Extensive debate has surrounded defensive maneuvers of target firms. The payment of greenmail is generally viewed as the most reprehensible of these, having been called "extortion" and "unfair, unjust and just plain wrong" (Meiser, 1984). Targeted share repurchases are payments that raiders accept to discontinue a hostile tender offer or potential takeover attempt. In these repurchases, the target firm buys the raider's shares back at a premium above what the raider initially paid for the shares in an offer but does not make the same offer to all shareholders. Thus, the raider benefits at the expense of remaining shareholders. Opponents of hostile tender offers point to this practice in their arguments against tender offers -- if hostile offers could be substantially limited, greenmail would not be paid.

III. The Evidence

A. Revaluation of Targets of Successful and Unsuccessful Tender Offers

Numerous studies have documented the returns to shareholders of target firms once a tender offer for control of the firm occurs. Jensen and Ruback (1983) summarize these studies and find that on average target firms in successful takeovers experience statistically significant abnormal returns around the announcement of the transaction of 20% in mergers and 30% in tender offers.[8] For a more recent sample of successful tender offers from 1981 through 1984, the SEC's Office of the Chief Economist (OCE, 1985a) identifies an average 53.4% premium (not correcting for overall changes in the market) received by shareholders of target firms. This study also considers the difference in premiums received when the offer is friendly or hostile and finds no significant difference between these categories. If the tender offer is initially friendly, shareholders receive an average 51.7% premium and if the offer is initially hostile, shareholders receive an average 55.5% premium.

The evidence on share revaluation suggests that raiders are able to identify firms whose shares are undervalued for some reason. If the market has simply priced these shares inefficiently and the use of the firm's assets under present management does explain the low valuation, then once the raider has identified the mispricing, the shares should be permanently revalued. Thus, any observed increase in share value at the time of a tender offer should be maintained even if the tender offer is unsuccessful.

Bradley, Desai and Kim (1983) investigate failed tender offers to determine if there is a permanent share revaluation. They find that if the failed tender offer is followed by a successful offer within five years, the targets' shares, on average, maintain the initial increase in value and further appreciate at the announcement of the following tender offer. However, if no tender offer follows within the next five years (that is, if the original offer can be said to be truly unsuccessful in that no change in control of the firm occurs), then share prices of those targets fall back to their original level during the period investigated. Bradley, et al., attribute the initial change in the value of the firm to potential "synergies" between the target and the acquiror. They suggest that these synergies may be attributable to "more efficient management, economies of scale, improved production techniques, the combination of complementary resources, increased market power, the redeployment of assets to more profitable uses, or any number of value-creating mechanisms which fall under the general rubric of corporate synergy" (p. 183-4). If the tender offer is not completed and is not followed by an offer from another party, then these synergies are not observed and the value of the firm returns to its original level. In short, a change of control is apparently required to achieve a permanent appreciation in the market value of the firm's equity. This evidence suggests that opponents of hostile tender offers are wrong when they argue that raiders pursue firms that the market has priced incorrectly. Rather, the evidence suggests that the raider serves a very real purpose in effecting change in a corporation.

Eastarbrook and Jarrell (1984) confirm the results of Bradley, et al. They find evidence to question the validity of a Kidder Peabody study (1983) that asserts the opposite result -- shareholders of defeated tender offers benefit from those defeats. Eastarbrook and Jarrell note that the Kidder study incorrectly adjusts for overall changes in the stock market in determining the value of shares in the firm following a defeated takeover attempt. Using conservative assumptions, they find that these target shareholders lose at least an average 15% of the value of their equity following the defeat.

Target managements often actively oppose hostile takeover bids on the grounds that the bidder is offering an insufficient premium over the share price and that through this opposition, they can encourage an auction for the firm. Jarrell (1985) confirms that in cases where litigation by incumbent management against the bidder results in competing bids, shareholders receive an additional 17% average premium over the period of the auction. He also finds that in cases in which litigation is not followed by a successful offer, target shareholders lose the entire premium from the initial bid. He suggests that "although litigious defenses (and regulations) that encourage auction takeover contests can benefit existing target shareholders, these gains must come at the expense of the shareholders of the acquiring firm and the firms that would have been targets if takeovers were cheaper" (p. 175).

B. Coerciveness of Two-Tier Tender Offers

The SEC's Office of the Chief Economist has investigated the issue of whether two-tier tender offers are coercive. (OCE, 1985a.) In their study of all successful tender offers from 1981 through 1984, they identify which offers are for "any and all" shares of the target company and which offers are for control of the corporation, followed by a second-tier offer once control is acquired. Partial offers are also considered in this study. They find no evidence to suggest any coercion in two-tier offers. Overall, two-tier offers are not frequently observed, especially in recent years. In 1984, 7 of 82 successful offers used a two-tier strategy and these two-tier offers were used predominately for the acquisition of very large firms. "Blended" premiums (the weighted average of premiums received in each tier of the offer) in any-and-all offers and two-tier offers are very similar -- 59.6% in any-and-all offers and 54.5 % in two-tier offers. The contention that shareholders of targets of two-tier offers are forced to accept relatively low premiums is not supported by this evidence.[9] It is the pure partial offer, in which no second-tier offer is made, which brings shareholders the lowest premium -- 34.4%. It is also found that in over two-thirds of the 38 successful two-tier offers from 1981 through 1984, there is less than a 20% difference between the two tiers refuting the premise that remaining shareholders are "squeezed out" of the firm. There is no evidence that a two-tier offer has been chosen when an any-or-all offer for the firm worth more was also available to target shareholders.

C. Institutional Stock Holdings and Long-Term Corporate Investments

As noted above, opponents of hostile tender offers have more concerns than whether target shareholders receive substantial premiums for their shares. Much debate has centered on how potential tender offers affect managers' decision making. There is no evidence to support the contention that managers are forced to emphasize short-run earnings at the expense of long-term investment to keep share prices high and to keep institutional investors from "churning" their portfolios, a factor allegedly leading to easier hostile takeovers. Two recent studies have found evidence to the contrary. In an extensive review of data detailing institutional ownership and research and development expenditures, the SEC's Office of the Chief Economist finds that institutional investor holdings and R&D expenditures have increased simultaneously, on average, over the past three years (OCE, 1985b). Indeed, regression analysis indicates that institutional investors seem to prefer firms with high R&D to revenue ratios. In addition, there is no correlation between changes in institutional holdings and R&D activity. Stock price evidence suggests that the capital market positively values major R&D projects. The net-of-market increase in the equity value of 62 firms making announcements of such projects from 1973 through 1983 was 0.80% over the two days following the announcement, a statistically significant change. A recent study by McConnell and Muscarella (1985) confirms this result.[10]

The SEC study also considers R&D expenditures for 57 firms that were targets of tender offers. (The other 160 firms in the sample of 217 targets of tender offers reported that their R&D expenditures were "not material.") The data reveal that the 57 firms had an average R&D-sales ratio of 0.77%, less than half of that of the industry control group. Data on target firms reveal that large institutional ownership does not necessarily result in hostile tender offers. The average percentage of equity held by institutional investors in 177 target firms was 19.3%, compared to an average 33.7% in an industry control group of nontarget firms. These data contradict assertions that long-term investment or large institutional ownership gives rise to hostile tender offers.

D. Adjustment Costs Imposed by Hostile Tender Offers

The argument against hostile tender offers that they force costly corporate restructurings, plant closings or layoffs ignores the basic principles of sound economics. Overall wealth changes in the economy should be the dominant factor considered in determining whether hostile tender offers are good for the economy. To argue that a small sector of the economy should be protected from changes caused by competitive forces is clearly harmful in terms of overall wealth of society. New technology forces certainly short-term costs on certain sectors, but it also tends to improve the wealth of society. Hostile tender offers do often result in substantial changes in running the firm. However, the changes caused by hostile tender offers are the result of economic pressures. It is very possible that the mechanism of a hostile tender offer is the least costly manner in which these changes may be implemented.

E. "Junk-Bond" Financing

In response to concerns that extensive leveraging with junk bonds may have a serious impact on the economy in the event of a recession, proponents of the use of junk bonds point out that the use non-investment-grade debt is not that widespread. In testimony before the Senate Subcommittee on Securities, Frederick Joseph, vice-chairman and chief executive officer of Drexel Burnham Lambert (the major underwriter of non-investment-grade debt), noted that of the total $122 billion used to finance mergers and acquisitions in 1984, less than 2 percent came from high-yield bonds. In an independent review of the data, the SEC's Office of the Chief Economist found that of all 119 tender offers initiated during fiscal year 1985, only 12 proposed any financing using non-investment-grade debt. Overall, the concern about the role of leveraging in hostile tender offers seems to overemphasize the role of junk bonds in financing these transactions. The concern over whether the bonds have sufficient value to be traded for shareholders' equity seems to be best left to shareholders.

IV. The Political Exchange

The political debate on hostile tender offers has taken many different paths. The business community, investors, the SEC and Congress have all been active participants. In this section we discuss some of the proposals that have been introduced by the several parties and try to summarize the debate as it stands today.

The SEC took the initiative early to carve out a comprehensive tender offer policy. The Williams Act of 1968 was based on the premise that public policy with respect to tender offers should be neutral. Thus, the Williams Act required adequate disclosure of the identity of the bidder and sources of financing. In addition, the Williams Act provided for a reasonable period in which target shareholders might consider the offer (the Williams Act provided for a 10-day offer period, recently extended to 20 days by Commission action) and also established a prorationing scheme to insure that shareholders are not forced to accept an offer on a first-come, first-served basis.

In 1983, the Commission established the Tender Offer Advisory Committee, consisting of well-known investment bankers, takeover lawyers, corporate leaders and economists to review regulations concerning tender offers and provide recommendations on regulatory and legislative reforms. In June 1983, the Advisory Committee sent 50 recommendations concerning tender offers to the Commission. The SEC's response resulted in a legislative package that would have prohibited a variety of protective devices including the payment of greenmail, the adoption of golden parachutes (special severance-compensation packages for managers) during a tender offer, self-tender offers during a tender offer and issuance of new securities worth more than five percent of the issuer's voting power during a tender offer. In addition, the proposed legislation would have shortened the 10-day filing period for investors to report the acquisition of more than five percent ownership of a firm.

This legislative package was not approved by Congress in the 1984 session and the Commission recently decided not to support most of its previous proposals. While the Commission maintains its support for closing the 10-day window in which to file notice of five percent ownership of a firm, it has decided to withdraw its support of the remaining proposals. In determining this position, the Commission noted that the market for corporate control is extremely volatile and that the outlawing of specific actions in such a dynamic environment would probably simply result in the "invention" of new defensive tactics.

Before the Senate Subcommittee on Securities recently, several corporate representatives presented their concerns about hostile tender offers and suggested legislation to control hostile bids. The Business Roundtable presented a comprehensive set of proposals that they believe would adequately prevent the abuses they perceive in the tender offer market. According to their proposals, any acquiror holding a threshold number of shares (perhaps 15%) would be required to make an any-and-all offer for the rest of the firm at a price at least equal to the highest price per share paid in acquiring the initial position. In the event of an offer, the board of directors would have to approve or disapprove of the offer within a certain period of time such as 10 days. If the offer is approved, then the tender offer would proceed as it does today. If the board disapproves of the offer, then a special meeting of all shareholders would be held to consider the adequacy of the offer. The vote to approve the offer would require an absolute majority of the outstanding shares of the shareholders holding shares on the day before the offer was made — thus eliminating the possibility that arbitrageurs and short-term holders of the shares could be involved in the control decision.

Others testifying at the same hearing included representatives from the National Association of Manufacturers, the New York State Business Council, Lazard Freres & Co. and Merrill Lynch. The general testimony of these individuals centered on the need to curb the "abusive" practices in hostile tender offers. Proposals included the extension of the minimum offer period to 60 days (from 20), the closing of the 10-day window for disclosure of 5 percent ownership, the requirement that an investor make a tender offer for 100% of the firm once he crosses a certain threshold of holdings and the requirement of more disclosure on sources of financing for tender offers. In addition, those testifying expressed concern over defensive tactics, requesting that "poison pills", greenmail and self-tender offers be limited.

The Administration, through the Council of Economic Advisors, has argued the position that there is no need for additional legislation or regulation. In the 1985 Economic Report of the President, the Council concludes that hostile tender offers serve an extremely useful role in providing an efficient and competitive economy. Though it recognizes that there are abusive practices in the market for corporate control, it suggests that most of these practices are defensive maneuvers by target management and that these practices are best corrected within the firm itself through means such as charter amendments that prohibit the payment of greenmail, two-tier takeovers and other objectionable practices. In addition, it argues that intervention in the conduct of corporate management traditionally is the subject of state regulation and it is unnecessary to introduce federal oversight into this area.

In general, the Administration (and especially its economic advisors) is increasingly sympathetic to raiders. The Economic Report of the President clearly takes the position that hostile tender offers play a very beneficial role in the economy. This argument relies primarily on the stock price evidence discussed in the above section and the general premise that the market for takeovers is basically efficient. Hostile takeovers are viewed as a critical check on inefficiency, complacency, mistaken policies or insufficient knowledge by incumbent managements in modern corporations whose owners do not directly control the companies.

However, these same officials have recently found themselves in a difficult position due to recent state court decisions. The Delaware court system approved both the adoption of a "poison pill" -- the authorization of preferred stock which makes a hostile tender offer prohibitively expensive -- in the Household International case and the discriminatory self-tender offer by Unocal which excluded shares owned by the Mesa Group. Both of these provisions have the effect of providing substantial defensive power to target management. Those who argue for less regulation in the area of hostile tender offers find themselves advocating SEC action to counter the distortions of state court decisions. The Council of Economic Advisors warns that "if the nature of competition among the States changes, and States that charter a significant percentage of publicly traded corporations adopt protectionist statutes or interpretations of law that promote managements' ability to abuse delegated discretion, then the limits of federalism as applied to the market for corporate control may have to be reconsidered" (p. 215).

V. The Outlook for Political Decisions

In this paper, we have reviewed the market for corporate control and the role of hostile tender offers in that market. In the multibillion-dollar market for corporate control, it is not surprising that the participants frequently turn to those with the power to make legislative decisions to change the rules under which the market operates. In arguing for change, economic positions are established. Those who oppose hostile tender offers and raiders argue that raiders buy up firms at bargain prices, paying an insufficient premium to target shareholders. In addition, it is argued that the fear of the raider results in over emphasis on short-term profits at the expense of long-term investments, abusive defensive tactics such as greenmail and poison pills, and harm to those who depend on the target firm for their livelihood.

Those who oppose limitations on the activities of raiders argue that the large wealth gains to target shareholders from hostile tender offers are due primarily to the potential acquisition of the firm by the raider and any corresponding changes in the operation of the firm, rather than to any mispricing of the security in the marketplace. Thus, it is essential that raiders be allowed to make tender offers for firms to insure that the overall economic base remains as efficient and competitive as possible.

The economic evidence supports the arguments of proponents of hostile tender offers. At the announcement of a tender offer, hostile or not, shareholders experience a significant wealth gain. Shareholders of recent target firms receive an average premium of over 50% of the value of their shares prior to the offer. If an unsuccessful tender offer is not followed by a successful tender offer within the next five years, shareholders of target firms receive, on average, no net gain, a factor arguing against the hypothesis that raiders simply identify mispriced firms. There is no evidence to support the contention that firms are forced to protect themselves from hostile tender offers through the misallocation of resources to projects with short-term returns at the expense of long-term investments. In fact, the announcement of major R&D investments is accompanied by positive, significant changes in share prices on average. There is no evidence that the economy is hurt on an overall basis from any forced closings of plants or layoffs of workers -- in fact, it is these types of changes which result in a stronger, more competitive economy.

Whatever the economic evidence suggests about the benefits of a free market for corporate control to our national economy, other factors are more important in determining the outlook for political actions. Although a vigorous, competitive and unfettered market for corporate control may be in the public interest, as the evidence indicates, this does not guarantee that it is politically optimal. Actual public policy is often at odds with prescriptions based on economic efficiency even when the empirical evidence condemns the policies. (Stigler, 1982.) Examples of economically inefficient public policy include many tariffs, agricultural price supports and minimum wage laws. These laws persist, however, because they concentrate benefits on politically effective groups while their costs are spread thinly over politically ineffective groups. The political economy of tender offer regulations is understood best by inquiring about who benefits and who loses from prohibitions on hostile tender offers.

This analysis requires in turn an understanding of the economic consequences of erecting further legal barriers to hostile tender offers. Although many corporate managements would use any additional "veto power" over hostile tender offers to benefit their shareholders, the weak empirical case for additional shareholder protection supports a prediction that some economically desirable takeovers would be deterred. The strong and vocal lobbying effort to restrict hostile takeovers seems to be motivated more by fear and anxiety among corporate leaders than by a desire to eliminate potential abuses of shareholders. Indeed, many restrictions on hostile tender offers recommended by corporate lobbyists, such as community impact statements, would not be tolerated if applied to negotiated mergers or ordinary business investments. Moreover, the use of state antitakeover laws before 1982 and the recent use of the new poison-pill defenses would seem to support the proposition that federally-granted veto power over hostile tender offers would be used more than is optimal for national economic welfare.

Potential acquirers would be harmed by new regulations that provided veto power over hostile offers to target managers, whether this power was used primarily to entrench incumbent management or to force the payment of higher takeover premiums. In either case, this veto power would raise the costs of acquisitions and deter some otherwise economically viable acquisitions. Because potential acquirers and raiders would be seriously harmed by these proposed regulations, these groups bitterly oppose them. However, these raiders are neither a large nor a politically effective lobbying group at present.

If the proposed veto power were used primarily to deter hostile takeovers that were economically efficient, then would-be target shareholders would also be harmed by these regulations. This group, however, is diffuse, comprised of small shareholders having low stakes and instititutional shareholders having diversified portfolios. The large absolute stakes of all institutional shareholders could lead to some effective opposition but their diversified portfolios make any one fund's relative stakes low compared with that of a prospective target management. For this reason, we cannot expect institutional shareholders to dominate this political debate.

The main beneficiaries of additional restrictions on hostile takeovers are incumbent corporate managements and local communities where potential target firms do substantial business. These groups understand their interests very well. They are well organized and have large and concentrated stakes in the outcome of corporate control battles. Indeed, many target management teams have willingly conducted extensive (and expensive) court battles when besieged by hostile bids. One can extrapolate these instances to other potential targets for an indication of the magnitude of the potential benefits that legislated veto power could create for incumbent managements.

Although the bidder's plight has received more sympathy lately from administration economists and certain regulators, a sober look at the political calculus leads one to predict that public policy will continue predominately to support the incumbent management of prospective target corporations. With the elimination of protection from state antitakeover laws in 1982 (with the MITE decision) and the lowering of the shield of antimerger enforcement, the leaders of the largest American corporations have joined the managements of small and medium-sized firms in advocating severe restrictions on hostile tender offers. At one point this spring, there were more than ten separate legislative initiatives competing for attention in Congress.

This powerful coalition for anti-raider legislation may be frustrated by an uncooperative Administration. It might be stalled by an SEC that insists on the protection of shareholder rights in corporate control above the insulation of incumbent managers from competition in the market for corporate control. But the political calculus strongly implies that the coalition of corporate and community leaders will eventually succeed in securing either outright veto power over hostile bids or the legal machinery to provide effective, reasonable cost methods to deter undesirable competitors for control of their corporations. The benefits of an unfettered market for corporate control are too diffuse and the benefits of anti-raider laws too large and concentrated to support any other prediction for the long-run outcome of the debate over hostile takeovers.

NOTES

* Financial Economist and Chief Economist, respectively. We thank the participants in the "Merger and Antimerger Games People Play" Session at the 1985 Western Economic Association meetings and, in particular, Alan A. Fisher and David Kass for many helpful comments and suggestions to improve this paper. Of course, all errors and omissions are our own. The U.S. Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission or of the authors' colleagues on the staff of the Commission.

1. Greenmail refers to targeted share repurchases in which target management buys back shares from potential raiders at significant premiums over market price in an offer that is not made to all shareholders. Poison pills are generally specially issued securities that give present shareholders rights that make hostile tender offers prohibitively expensive. Shark repellents are charter amendments introduced by firms, such as supermajority approval requirements for mergers or acquisitions or fair price provisions, that make mergers or acquisitions more difficult.

2. The U.S. Supreme Court removed a threat to the market for corporate control when it struck down the Illinois Business Take-Over Act on June 23, 1982 (Edgar v. Mite Corp., 102 S. Ct. 2629 (1982)). In doing so, the Court ruled that the law was pre-empted by the Williams Act and was overly burdensome to interstate commerce. This decision has had a far-reaching impact on state legislation with respect to the market for corporate control. (See Jarrell, 1983, for discussion.)

3. Jensen (1985) provides this analysis of hostile tender offers in the petroleum industry.

4. Jarrell and Bradley (1980) develop a theoretical explanation for the treatment of raiders as patent holders. Easterbrook and Fischel provide an extensive discussion on the need to protect the innovators of information about a target firm from appropriation of those wealth gains by alternative bidders.

5. In an investigation of proxy contests, Dodd and Warner (1983) report that for the 96 contests in their study, about one-fifth resulted in dissidents obtaining a majority of board seats. They also report that proxy contests are associated with a positive revaluation of the firm's shares and that this positive revaluation is not necessarily found only if the board is completely replaced. Through such mechanisms as cumulative voting, dissidents usually obtain at least one seat on the board. Dodd and Warner suggest that this increase in the value of the firm is attributable to expectations of improved management performance as a result of the challenge.

6. In a recent Wall Street Journal editorial, Drucker (1985) suggests that the fear of a takeover attempt "contributes to the obsession with the short term and slighting of tomorrow in research, product development, market development and marketing, and in quality and service -- all to squeeze out a few more dollars in next quarter's 'bottom line'." Herzel and Schmidt (1985) argue that it is extremely difficult for the benefits of long-term planning to be reflected in stock prices because the outcome of long-term planning is impossible to predict. They suggest that the ability to accurately judge the potential success of long-term planning "is closer to an act of faith than it is to rational calculations."

7. Bidders who plan to use junk bonds in financing hostile tender offers often state in their SEC filings that the bids are "subject to financing." An additional concern raised by some SEC regulators regarding junk bonds suggests that these qualifications allow bidders to manipulate the markets without fully committing themselves to the purchase.

8. These premiums are found through the use of the market model methodology. In general, this technique removes overall market influences from stock prices to identify the impact of firm-specific events. Some researchers have questioned this methodology in that changes in share prices to shareholders at the time of the acquisition may not reflect overall efficiency gains to the economy from the takeover (Fisher and Lande, 1983).

9. These averages do not control for other factors such as size of the firm, managerial and institutional holdings and financial conditions of the firm such as debt-equity ratios. Walking and Edminster (1985) identify several factors that seem to determine premiums.

10. However, McConnell and Muscarella find that announcements of increases in exploration and devlopment expenditures by oil companies in the period 1975-1981 were associated with systematic decreases in the announcing firm's stock price. They suggest that this result is attributable to the overproduction of oil reserves and the slowing in oil prices observed in recent years.

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THE WALL STREET JOURNAL.
May 1, 1985

Takeover Threats Don't Crimp Long-Term Planning

By Gregg A. Jarrell
And Kenneth Lehn

Critics of hostile tender offers argue that such threats are inducing corporate managers to defer research and development and adopt a variety of defensive tactics ranging from "golden parachutes" to anti-takeover charter amendments. If this were the case, one would expect to find evidence that managers are maximizing short-term earnings at the expense of long-term projects, such as research and development. But a study we conducted as economists at the Security and Exchange Commission indicates precisely the opposite.

Critics of hostile takeovers have argued that these defensive actions and the increasing neglect of long-term projects are visible symptoms of a serious economic problem. Their central point is that hostile takeovers result largely from undervalued equity of the takeover target. This fundamental problem is attributed to large holdings of institutional investors in most publicly held corporations. These professional managers of billion-dollar portfolios operate in an intensely competitive environment. Their focus on short-term earnings reports, the argument goes, is a natural consequence of the pressure on them for short-term performance.

This points to a troublesome side effect. The contention is that a capital market dominated by competitive fund managers causes equity prices to favor short-term earnings reports disproportionately to long-term prospects, that the shares of firms with significant long-term programs sell at lower prices than those of comparable companies that maximize their immediate earnings, and that this environment creates openings for hostile takeovers.

This scenario of the causes and consequences of hostile takeovers has been widely publicized. Three articles in The Wall Street Journal in the past few months by authors with outstanding credentials (Martin Lipton, Felix Rohatyn and Peter Drucker) have advanced these arguments. Key congressmen have expressed support for the theory in hearings, and several anti-takeover bills have been proposed in response to this alleged problem.

However, this theory is based on very shaky empirical evidence. In fact, no advocates have provided supporting facts. They have relied instead on the "reasonableness" of this argument, and anecdotes. This neglect is quite surprising because of the economic sophistication of the proponents and because the theory has many direct empirical implications that can be tested with readily available data.

The SEC's Office of Chief Economist conducted a study of the relationship between institutional ownership of public companies and their R&D expenditures. Specifically, data were collected on 324 companies representing a cross-section of 19 R&D intensive industries, including aerospace, drugs, oil, timber, steel, semiconductors and telecommunications. For the years 1980-1983, measurements were made of the percentage of common equity held by institutions and the ratio of such companies' R&D expenditures to their total revenues.

The aggregate data reveal that as average institutional ownership has increased (from 30% in 1980 to 38% in 1983), so has the average R&D-to-revenue ratio (from 3.38% in 1980 to 4.03% in 1983). Thus, there is no evidence that the increasing institutional ownership has induced companies to curtail their R&D programs.

For each company, the relationship between the 1980-1983 change in institutional ownership and the 1980-1983 change in R&D-to-revenue ratio was closely examined. The purpose was to test the theory that rising institutional ownership causes companies to curtail their R&D expenditures. The facts show the opposite to be true. Apparently, institutional fund managers show a noticeable preference for firms with increasing R&D expenditures.

The study also examined the 217 firms that were takeover targets between 1981-1984 in an effort to isolate any patterns between institutional ownership and R&D expenditures for actual targets. First, 160 of these target companies reported that their R&D expenditures were "not material." For the remaining 57 firms, the data show that over the four years preceding their takeover, they had R&D-to-revenue ratios (0.76%) only half as large as the average for the other firms in their respective industries (1.53%). These data show that the target firms of the 1980s are characterized by very low R&D expenditures. Again, this fact contradicts the view that investment in long-term projects such as R&D makes firms vulnerable to takeovers.

The ownership structure of these 1981-1984 takeover targets was also examined to see if institutional ownership in these firms was unusually large. Ownership data were available for 177 target firms. Contrary to the prediction of the theory, the percentage of equity held by institutional investors in target firms (19.3%) was significantly lower than the corresponding average percentage for non-target firms in the same industry (33.7%). These data strongly suggest that institutional ownership per se does not fuel takeovers.

The proponents of the theory have asserted that stock prices decline in response to increasing R&D expenditures. This is another direct implication of the theory, and it too had not been systematically tested for validity. Our study examined the net-of-market stock price reaction to 62 Wall Street Journal announcements between 1973-1983 that firms were embarking on new R&D projects. These tests show that, on average, the stock prices of these firms increased (1% to 2%) in the period immediately following the publication of these stories. Again, this direct implication of the theory is refuted by the data.

Although these data refute the theory, we do not expect them to silence the critics of hostile tender offers. The dramatic human consequences of hostile tender offers give rise to claims and counterclaims about their economic and social desirability. However, policy makers should insist on empirical evidence, rather than rhetoric. Isolated anecdotes can be found to support any theory, and therefore prove none. Empirical evidence offers policy makers the best hope for intelligent decisions.

Mr. Jarrell is the chief economist and Mr. Lehn is the deputy chief economist of the Securities and Exchange Commission.

THE WALL STREET JOURNAL, WEDNESDAY, JUNE 5, 1985

REVIEW & OUTLOOK

Takeovers: The Market Test

> *Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary. . . . The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates. . . .*
>
> *The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process or industrial mutation—if I may use that biological term—that instantly revolutionizes the economic structure from within, incessantly destroying the old, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in. . . .*
>
> *[T]he problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.*
>
> *Joseph A. Shumpeter*
> *"Capitalism, Socialism and Democracy"*

So the greatest economist of our century described the essence of capitalism. And after listening to the big debate on corporate takeovers this year, we found our way back to his great book and particularly the chapter "The Process of Creative Destruction." For the longer we've thought about the subject the less we've come to fear a "takeover mania." Instead we fear some heavy-handed congressional regulation, if indeed the Delaware Supreme Court has not already gone too far with its recent ruling handing managements new defensive powers. The danger in inhibiting takeovers is cutting off Shumpeter's creative destruction.

Readers of this page have been able to follow a remarkable airing of the sides of the takeover debate: raider Sir James Goldsmith (Feb. 11), poison-pill inventor Martin Lipton (April 5), investment banker Felix Rohatyn (April 18), Prof. William J. Carney of Emory University (April 29), Gregg Jarrell and Kenneth Lehn of the SEC (May 1), Sen. Pete Domenici on his bill to regulate takeovers (May 14), Frederick Joseph of Drexel Burnham Lambert in defense of "junk bonds" (May 31).

Critics of takeovers like Mr. Lipton, Mr. Rohatyn and Sen. Domenici have undoubtedly been able to identify some problems. But many of them are either not unique to takeovers (high leverage) or already being sorted out in the marketplace (greenmail). On balance we have been more impressed by the arguments of the defenders. In particular, they can show that much of what is being criticized is legitimate investment banking—creating new financial instruments and new corporate structures more suited to the contemporary marketplace.

This is perhaps most easily seen by focusing on one issue, the "restructuring" of the oil industry. T. Boone Pickens gave his views on this issue in a Jan. 8 letter, and it was addressed quite independently of the takeover battles in a Feb. 21 article by John Sawhill of McKinsey & Co. The turbulence of energy prices in the 1970s has completely changed the environment for the oil industry, creating a glut of refinery capacity, leaving producing nations rather than international companies in control of oil reserves and greatly enhancing the importance of the spot market for crude oil. In these new conditions, the traditional vertically integrated oil company is no longer necessarily the best answer for either the investor or the consumer.

Creative Destruction—I

An Editorial Series

The problem is how to shed inefficient refinery capacity, take advantage of the spot market, and return cash flows from oil production to the capital markets so they can be redirected to other opportunities. It is not impossible to do this within the structure of present oil companies; refineries and retail outlets are being closed. Exxon, surely not under any takeover threat, has repurchased some of its shares, a way of returning money to the capital markets. But inertia attaches to any large bureaucratic structure, and even when raiders have not succeeded in ousting managements they have often been the catalysts for necessary restructuring.

This is certainly not to say that every takeover proposal is economically justified, let alone that the raiders are motivated by a public-spirited desire to improve economic efficiency. But legislators or judges who have to decide on takeover law ought to read "The Market for Corporate Control" in February's report by the Council of Economic Advisers, which concluded that takeovers add to economic efficiency and wealth, and should be not discouraged but encouraged.

In particular, it's important to remember that greed is disciplined by the marketplace, that by and large takeovers succeed only if a broadly diversified market approves. Wall Street still echoes with laughter at the cashless bid for CBS by Ted Turner, who is probably not motivated solely by economic considerations. Few such flimsy offers ever reach public prints. More often raiders are going to pick companies on which they think they can make money, junk bond dealers and buyers will back deals on which they think they can make money, the arbitragers will buy only if they think they can make money on a successful deal. And shareholders will sell only if the stock price goes up.

The market test of hostile takeovers may not provide absolute proof that every deal is an example of Creative Destruction at work. But the market, we submit, is a far better test than anything Congress is likely to devise.

THE WALL STREET JOURNAL, MONDAY, JUNE 10, 1985

REVIEW & OUTLOOK

Abuses, Real and Imagined

Nearly everyone agrees that a certain amount of corporate takeover activity is a good thing, serving what Joseph A. Shumpeter christened "The Process of Creative Destruction"—capitalism destroying old structures and creating new ones. Even critics who worry about the fairness of takeover rules tend to agree that times do change, that corporate structures must change accordingly, and that the takeover threat is a useful spur.

We have been seeing a lot of takeover attempts because the economic environment has been changing rapidly, not least because of macroeconomic blunders between 1965 and 1980. The inflation wrought by a guns-and-butter fiscal policy and a monetary policy cut loose from its previous gold anchor created a bubble that was pierced by the near-collapse of the dollar and the resulting appointment of Paul Volcker in August 1979. As inflation went up we experienced a round of takeovers as part of the adjustment to the new environment, and as it abates we are quite predictably experiencing another for the same reasons.

Creative Destruction—II

An Editorial Series

So what's the problem? Number one on most lists is the creation of debt; no matter whether raiders or defenders win, equity is usually replaced by debt. Some feel that debt for takeovers is nonproductive, and will "crowd out" borrowing for better purposes. Yet when funds from the newly acquired debt are paid to shareholders, they do not put them in mattresses. Most likely, they reinvest them. If you believe in markets, indeed, the funds paid to shareholders will be directed into more lucrative opportunities. So future cash flow of Target Company is being used to pay down debt that was in effect invested in Upandcoming Company. The capital markets have reallocated funds to better investments.

Everything will be fine provided Target Company's cash flows can service the debt, and markets are not likely to accept debt they believe will not be repaid. Of course, their expectations may be disappointed, particularly if there are further macroeconomic blunders. This is not an argument against takeovers, but against a tax system that rewards leverage by allowing corporations to deduct interest payments but not dividends.

A second problem, now acknowledged by many of the raiders themselves, has been greenmail. Strictly defined, greenmail is the purchase of the raider's shares by the target corporation at a price not offered to other shareholders. Frequently raiders make big profits from failed takeovers if the stock is bought out by white knights or other bidders. So long as they get the same price as other shareholders, they can walk away feeling they have been catalysts for creative destruction. But if the raiders' shares command a premium, other shareholders' funds have been used to enrich the raiders and entrench the management. Greenmail strictly defined has by now practically vanished; neither raiders nor managements have found it worth the long-run price. But the suspicion that raiders are out for greenmail colors takeover attempts, providing much of the impetus for proposed limitations in Congress and the courts.

Yet surely greenmail is more of an abuse by the managers than by the raiders. If there is a big problem with hostile takeovers, it is that as the biggest potential victims, the managers of a target company, have interests in conflict with those of their shareholders. So most takeover critics at least profess to worry about not only the tactics of raiders but those of defenders. Indeed, the critics tend to fasten on "golden parachutes," though in fact generous severance contracts for management tend to align its interests with shareholders', actually working against the inherent conflict of interest.

As for defenses that actually protect management, shareholder approval solves a lot. Who can really complain if a company convinced shareholders that their long-term interest lies in protecting the present structure? One example is our parent, Dow Jones, which as a media company is potentially vulnerable to takeover attempts based on noneconomic motives. Nor is shareholder approval automatic, as the rejection of Rorer Group's "poison pill" showed last month. Given the inherent conflict of interest, a certain suspicion should attach to the desperate measures adopted in the heat of battle and without shareholder approval, even if these measures are defended as attempts to even the odds against "coercive" tactics by raiders.

The coerciveness supposedly results from "two-tier" tender offers. The raider offers to buy 51% of the company now, and 49% later. If the prospect is that the 49% will get less, the shareholder has a big incentive to side with the raider or miss the best price, and thus the deal is decided by this tactical advantage rather than assessments of long-term economic potential. It's far from clear that this problem is as serious in the real world as it is in theory; an SEC study of the issue found no evidence two-tier offers were effective in any coercion, and they are frequently used in friendly as well as hostile takeovers.

In any event, any advantage raiders got from two-tier offers has been at least evened by the Delaware Supreme Court decision in Unocal vs. Mesa Petroleum. The court has invited management under attack to counter with its own even more discriminatory two-tier offer. And given this outcome, the present issue is not whether raiders should be stopped but whether regulators have already gone too far in erecting obstacles to takeovers, protecting current corporate structures and thwarting the possibility of Creative Destruction.

THE WALL STREET JOURNAL, WEDNESDAY, JUNE 12, 1985

REVIEW & OUTLOOK

The Delaware Tilt

In one of the biggest tender offers of the year, R.J. Reynolds is offering to buy 51% of the shares in Nabisco for $85 a share in cash. A big hunk of cash flow from tobacco—surely a dying industry—is being paid to shareholders in a cookie company. Most of the shareholders who receive this payment will no doubt invest it in other opportunities, and probably more promising ones. Surely the merger is a good example of Joseph A. Schumpeter's "Creative Destruction," capitalism creating new structures to meet new market demands.

The Reynolds-Nabisco case, of course, is a friendly takeover. Reynolds will achieve further diversification out of tobacco. Nabisco CEO F. Ross Johnson will become number two in the much larger company. Nabisco shareholders, whose shares were trading at about $60 a month ago, will take home a tidy profit. Though the bond rating agencies tut-tutted and Standard & Poor's marked down Reynolds's bond rating, everyone else is happy.

Creative Destruction—III

Last of a Series

Of course, not all shareholders will get $85 in cash now. When Reynolds gets its controlling 51%, the remaining 49% of the shares will be exchanged for $42.50 in senior debt securities and preferred stock with a "stated value" of $42.50. The deal was put together by Wall Street firms whose very names reek respectability—Dillon, Read and Co., Morgan Stanley & Co., Shearson Lehman Brothers Inc. And we've yet to hear a word of complaint about this two-tier offer.

Yet the same offer would surely be criticized as "coercive" if it were made without the permission of the target company's CEO. And if the offer were made by someone who'd been in the news as a corporate "raider," advised by racier Wall Street types, the target company could reply with an even more uneven two-tier offer: as much as it wants for shares owned by shareholders it liked, but nothing for those owned by shareholders it didn't like. At least, so the Delaware Supreme Court has just held. This precedent in the state where most corporations are chartered ought at least to end any allegations that in hostile takeovers the rules are stacked in favor of the raiders; it tilts the table enormously toward incumbent management.

The Delaware case is Unocal vs. Mesa Petroleum, the first clear defeat for T. Boone Pickens in a succession of oil company tenders. In justifying the Unocal defensive counteroffer as a valid "business judgment" with which courts should not interfere, the Delaware ruling seems to represent a vast expansion of the rights of management to defend itself against hostile takeovers.

Mesa had offered $54 a share in cash for 51% of Unocal, with the other 49% to be exchanged for a combination of debt securities and preferred stock. Unocal responded with an offer to exchange 29% of its stock for $72 in debt securities, but stipulated that it would not accept the shares held by Mesa. Lower courts ruled against the Unocal offer, on the ground that all shareholders must be treated alike.

The Delaware Supreme Court, however, held that it was reasonable for Unocal to conclude its shares were worth more than $54, that Mr. Pickens was primarily interested in "greenmail," and that it had a duty to protect shareholders from the coercive choice of "accepting $54 in cash or later receiving $54 in what the board has concluded are junk bonds."

Continued on next page

THE WALL STREET JOURNAL, WEDNESDAY, JUNE 12, 1985--Continued

After the ruling, Mr. Pickens and Unocal Chairman Fred Hartley negotiated a standstill in which Mr. Pickens gave up his takeover attempt and agreed to sell his shares only slowly, but was allowed to tender shares for the $72 offer. In addition to repurchasing shares, Unocal is also restructuring itself by spinning off its reserve holdings into new partnerships with more favorable tax treatment and thus higher value for shareholders.

The notion that in the context of a proxy battle a company can make payments to some shareholders and exclude others, though, breaks new legal ground. Sensitive to the implications of its own logic, the court remarked in its initial decision: "We caution boards of directors of Delaware corporations that they do not have unbridled discretion to defeat any perceived threat to corporate control by any Draconian means available."

It will be interesting to see if this big victory for incumbent management ends congressional proposals to limit takeovers. At last count there were 20-odd bills in Congress to limit tender offers, or at least "balance" the rules of the game.

We would be astonished if Congress showed any particular interest in tilting the tables back toward hostile takeovers; what congressmen bring to the table is the desire to preserve industries and jobs in their particular constituencies. Their incentives lie predominantly in impeding the process of creative destruction; politicians do not like an uninhibited marketplace they cannot control. In all likelihood legislation would lead to overregulation. For our tastes, indeed, the Delaware ruling already goes too far. But the justices are at least sensitive to the problem, and the law evolves under competition between raiders and managers.

For our own part, the more closely we look at hostile takeovers the more we are convinced that while there may be occasional problems and abuses they are generally a healthy activity. Capitalist structures need to evolve, and we certainly are not willing to leave the evolution solely to incumbent managements that represent the old order. We find ourselves sympathizing when in defense of his controversial activities, a Carl Icahn argues that we would not have the Rust Belt today if it had been possible to "pierce the establishment" in the steel industry 20 years ago.

It is intriguing, too, that the recent wave of takeovers has a premise opposite the last one. The old tendency was to build conglomerates that supposedly gave better "financial management." Now the raiders offer to bust up conglomerates, arguing shareholders would do better with more entrepreneurial management in several separate companies. We find the current premise the more plausible one.

As Schumpeter's phrase suggests, capitalism is not a tidy process. He was pessimistic about its long-term future, partly because [illegible] productive powers would be undermined by efforts to tidy it up and make it respectable. This is precisely what we ought to fear when we see Congress and the courts rushing to give new weapons to managers of big corporations to fight the depredations of raiders who want to give shareholders more money. The corporate managers look like big boys to us. The raiders may be a bit rakish, but to a far greater extent than managements, they play with their own money. Let 'em sort it out in the marketplace.

THE WALL STREET JOURNAL, TUESDAY, JANUARY 6, 1986

REVIEW & OUTLOOK

Is There Too Much Debt?

Everyone seems to be talking about debt. Year-end reviews of the economy describe the billions borrowed for corporate takeovers, consumer credit and the federal deficit. Various financial seers worry that a mountain of debt will collapse into a financial crisis, and rising debt has worried the Federal Reserve into a proposal to apply margin requirements to certain takeovers.

As we look at the figures, though, it's hard to discern anything like a debt crisis.

No one worries about normal kinds of borrowing for capital improvements; so long as the extra profit from the improvements can pay off the bonds, this is how economies grow. In fact, this borrowing is a large hunk of the new debt; corporations have been borrowing heavily this year to replace and improve their means of production. Everyone recognizes this as healthy.

What worries the worriers is debt issued in takeovers, leveraged buyouts and the rest. This money is not used to buy new machines, but paid to shareholders. How this adds to future production is not obvious, unless you ask what the shareholders do with the money they receive. If they reinvest it in better opportunities, the debt should count as money returned to the capital pool by mature industries to finance growing ones. As Harvard and Rochester economist Michael Jensen puts it, "Additional debt increases efficiency by forcing organizations with substantial cash flows but few high-return investment projects to disgorge cash to investors."

A lot of such debt is being issued right now in response to "disinflation" and the change in opportunities it produces. Many firms were busy last year restructuring their balance sheets. Companies in some industries are finding that with low inflation, their returns on normal investments are falling. Two results are an unprecedented amount of stock buy-backs and the takeover boom. Other companies have been borrowing to improve numbers on their balance sheets so as to avoid being taken over.

Oil companies are the best example. They have plenty of cash but no good investment opportunities. The market went wild over the mergers that caused restructuring. Shareholders gained more than $17 billion from the mergers of Gulf-Chevron, Getty-Texaco (before the infamous Texas court ruling) and Du Pont-Conoco.

There is some concern among the Fed and others about these new balance sheets. Companies now show ratios of liabilities to assets of more than 50%, higher than any since World War II. But Boston University finance professor Robert Taggart notes that during inflation, accounting overstates debt and understates the replacement value of assets. He says we need to look not at the ratio of debt to "book value," but at the ratio of debt to total capitalization at *market* value. This ratio was just 27% in 1984, far below the postwar high of 38% in 1974.

Consumer borrowing also seems explainable. The Federal Reserve Bank of Kansas has issued a report called "Rising Household Debt in Perspective." The perspective is that while household debt rose for much of the year, the net worth of households is also rising. The ratio of liabilities to total assets has been stable throughout the recovery.

Federal debt has been rising, reflecting the embarrassment of uncontrolled federal spending. Gross federal debt outstanding reached a postwar low of just under 35% of GNP in 1981, as the government inflated away old obligations owed in nominal dollars. With the current deficits it is approaching 45% of GNP, but this level has proved manageable before. Gross federal debt was nearly 120% of GNP in 1945, 58% at the start of the economic boom in 1960 and around 45% when the inflation started in the late 1960s.

Of course, federal spending ought to be reduced to something closer to the 19%-20% of GNP the tax system generates in federal revenues. It is also certainly true that the tax code promotes corporate debt instead of equity, since corporations deduct interest payments but cannot deduct dividends. If they want to return their cash flow to shareholders and the capital pool they have an incentive to do so through debt instead of directly. Correcting this problem—the tax bill working its way through Congress takes only a token step—is the one clearly sensible thing to do if you are worried about corporate debt.

So far as we can see, though, no more drastic action is necessary or appropriate. For the most part, the growth of debt looks to us like the by-product of an economy righting itself, a process that, needless to say, should be allowed to continue.

HOSTILE TAKEOVERS

Four Dollars

Winter/Spring 1986

THE BROOKINGS REVIEW

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Deficit Reduction and the Economy

Economics of Corporate Takeovers

Douglas H. Ginsburg and John F. Robinson
on the Case Against Federal Intervention

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Economics of Corporate Takeovers

The Case Against Federal Intervention in the Market for Corporate Control

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The recent surge of corporate mergers, marked by a high incidence of hostile takeovers involving some of the nation's largest corporations, has raised two broad questions: Are corporate takeovers good or bad for the economy? Should the federal government intervene in the acquisition process?

In December the Brookings Center for Public Policy Education gathered together a group of corporate, financial, government, and legal leaders to discuss their concerns about takeovers. The following two articles were prepared at the Review's invitation by participants in that conference.

WITH ONE notable exception, the United States has traditionally relied on the owners of the business — the shareholders — to decide whether a proposed business combination should take place. The exception is for mergers that are likely to have serious anticompetitive effects, that is, where there is a strong public interest in the outcome because the companies would be able to charge monopolistic prices. Federal law charges two agencies, the Department of Justice and the Federal Trade Commission, with the duty to investigate and prevent combinations that seriously threaten competitive harm. Apart from that narrow exception, which is outside the scope of this article, Congress has consistently sought to be scrupulously neutral, neither encouraging nor discouraging mergers that are not anticompetitive.

Some argue that it is now time for the government to abandon its neutral stance and enter the fray. These critics and the popular press breathlessly report that we are embarked on an era of skyrocketing "merger mania" that will harm the economy if left unchecked. Recent statistics on mergers help put our present situation in perspective. The number of transactions (measured broadly to include divestitures and "going private" transactions) was about 3,000 in 1985, approximately 20–25 percent more than the relatively constant number of transactions each year between 1975 and 1984. The largest number of transactions occurred, however, in 1968: 6,107, or twice the 1985 level. Moreover, during each of the seven years from 1967 to 1973, the level of transactions equaled or exceeded the 1985 level.

The number of transactions is only part of the story, of course. An important change has occurred in the dollar volume of such transactions and, in particular, the number of very large companies that now are being acquired or are going private. The first $1 billion transaction was in 1970; by 1978, only four more deals of that size were concluded. In contrast, 18 such deals (three of them over $5 billion) were completed in 1984 and 24 in 1985. Even after adjusting for inflation, the 1985 dollar volume now exceeds the prior peak in 1968 by about 40 percent.

While these statistics may or may not suggest a merger mania, they certainly help explain why the subject is receiving so much attention. It is no longer a

"It is not possible to say, however, that all, or even most, transactions of a particular type are harmful . . . ."

simple matter of big companies acquiring small ones. Some of the country's largest and most familiar companies are being acquired, restructured, or taken private. Large numbers of shareholders and employees are being affected. And the professional managers of the Fortune 500 companies have discovered that the massive size of the companies they manage is no longer a prohibitive barrier to shareholder challenges to their control through a "hostile takeover"—an acquisition that is opposed by the management of the target company.

Although most of the public debate has focused on hostile takeovers of large companies, only five of the 24 $1 billion transactions in 1985 arose from hostile takeover attempts. It should not, however, be surprising that hostile takeovers spark the most intense interest; conflict is more dramatic news than concord. Also, managers of large corporations are speaking out against the possibility of challenges to their control now that they find themselves vulnerable to being on the wrong side of a takeover challenge. Indeed, a coalition of corporate executives recently formed "Stakeholders in America" to oppose hostile takeovers. And some managers have resorted to extreme and even destructive tactics in their attempts to fend off such challenges.

Benefits, Costs, and Public Policy

Not even managers who oppose hostile takeovers dispute that mergers in general can and often do benefit the economy. They can directly increase the country's wealth and productivity. Mergers can result in joint operating efficiencies that enable the same products or services to be delivered at a lower cost. They can make it possible to realize economies of scale or scope, as well as financial economies. They can provide both the acquiring and target companies with resources—capital, management, or technology—that lead to new or better products than either company could have developed independently.

Mergers and takeover attempts, even unsuccessful ones, can also identify undervalued assets, causing them to be more appropriately valued or to be redeployed in a more valuable use — an extremely important function for the economy's productivity. Acknowledging such a role for takeovers does not imply that the managers of companies that are takeover targets are either lazy or stupid. The available evidence indicates they are not. It merely requires one to believe that they are not perfect and that it is possible for someone else to make a company's assets still more valuable to shareholders, even if the company has been a strong performer in its industry. Disagreement over this point is at the root of the debate over whether hostile takeovers are good for the economy or not.

Hostile takeovers perform another very important function for the economy, one that is different from the friendly merger. They provide an antidote to the "agency problem" that is associated with widely held public corporations. The agency problem stems from the sometimes significant divergence of interests between the owners — that is, the shareholders — and the managers who, as the owners' agents, run the corporation. Because the shareholders find it difficult and costly to act in concert, and the managers are able to use the resources of the corporation to defend their position, it can be prohibitively expensive and time consuming for shareholders to replace their management by use of the proxy machinery.

The hostile takeover attempt can be the only effective way for the shareholders to overcome the agency problem and receive full value for their ownership of the corporation. It is also often the most efficient way in which a competing management team can "go over the heads" of incumbent managers and make its case directly to the shareholders. More important, while an actual takeover provides such a remedy, even the threat of a hostile takeover attempt can be an effective incentive for incumbent managers to review their operations continually and to make sure they are getting the most value out of the assets they are charged with managing.

Notwithstanding the good for the economy that can come from mergers — hostile and friendly — a merger can also destroy wealth by moving assets to less efficient hands. We saw examples of such errors during the conglomerate building era of the late 1960s and early 1970s. We are witnessing the fallout from that period in the divestiture programs that many companies have now begun in order to focus their energies and resources on the businesses they know best. Indeed, about one-third of today's corporate acquisitions involve a seller divesting a firm acquired at an earlier time. But these examples simply illustrate the fact that sometimes business people err, which is neither surprising nor avoidable.

Because many mergers and acquisitions may not deliver the efficiency-enhancing gains that were originally expected by the parties involved — indeed some have resulted in significant losses — some have suggested that the federal government should step in to discourage takeovers that appear to be nonproductive. Most such critics would have the government intervene only in cases where they see harm — for example, hostile takeovers and the use of high yield securities are two favorite targets. It is not possible to say, however, that all, or even most, transactions of a particular type are harmful, especially since the mere possibility of a hostile takeover has a salutary competitive effect of unknowable significance.

The key question, then, is whether the government or some governmentally appointed agent of the public interest can distinguish, in advance, between individual transactions that will be good and those that will be bad for the economy. Can the government determine whether a merger will work out in the efficient and profitable way that the parties are betting it will? We think it is clear that the government is incapable of making that judgment.

It is important to keep the nature of these transactions in mind. They are capital investment decisions, similar to other business decisions, such as new product development or new plant construction, except that the stakes are often larger. Sometimes the decision turns out very right, sometimes very wrong, and sometimes in between.

Government decision-makers, who do not have their own money at stake, are sure to be less accurate than the parties themselves in evaluating the business prospects of a merger. Government agents are also necessarily less familiar than the parties with the business and the particular companies. Nor does the government have any better access to aggregate data or confidential information that would alter the parties' evaluation of the transaction if only they were aware of it.

If there is no decision rule that can be devised in advance and no public authority that can be set up to evaluate individual mergers correctly, the next question is whether mergers or hostile takeovers are, on average, good or bad for the economy. Unless it is clear that they are bad for the economy, we should not discourage them. Three types of empirical data shed some light on this question. No one of them is flawless, but some of the studies are far more rigorous and persuasive than others.

The primary data on the effects of these transactions come from "event studies," conducted by financial economists who track the behavior of stock prices before and after tender offers. The second type consists of accounting studies, which focus on the profitability of firms engaged in merger transactions. The third type of information is the anecdotal experience of critics of hostile takeovers, principally corporate managers.

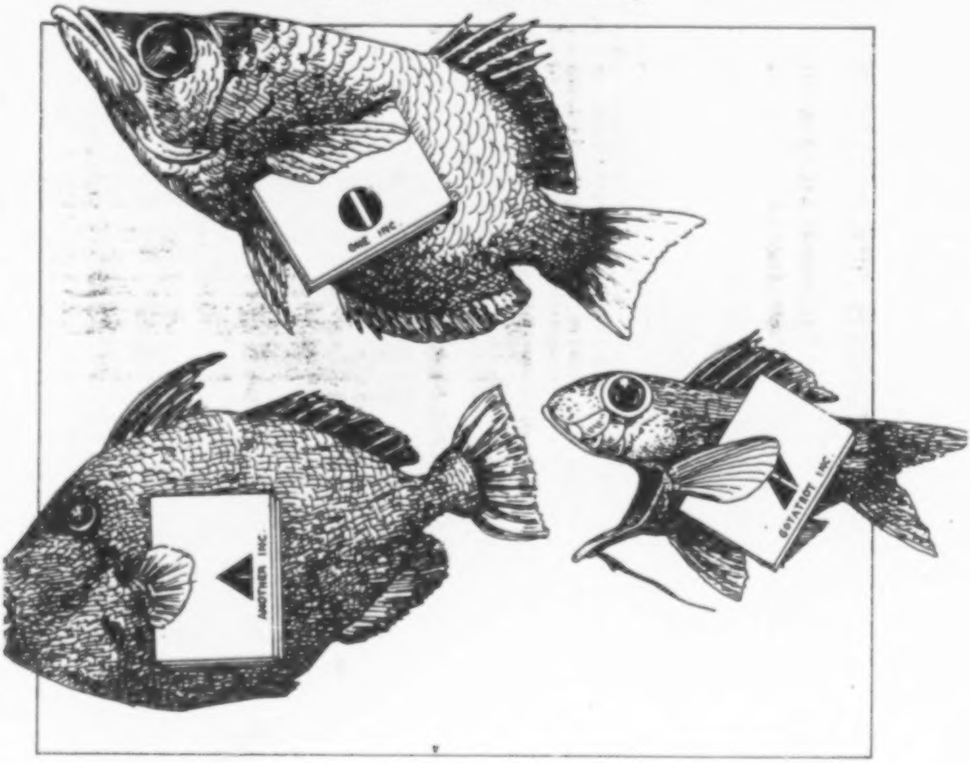
ONE INC.
ANOTHER INC.
GOTATROT INC.

Illustration by Lou Gladstone

"Clearly the judgment of the market is that, on average, takeovers are likely to increase the value of both companies."

Evaluating the Data

Event Studies

The best information comes from the stock market's reaction to events during takeovers. The data are timely, forward-looking, comprehensive, and avoid problems associated with accounting conventions and taxes. The studies of stock prices reveal the consensus of all the participants in the market as to the expected value of the takeover proposal to shareholders of both the acquiring and acquired companies.

This evidence is unambiguous. In successful tender offer acquisitions, shareholders of the target company typically gain a premium of at least 30 percent over the pre-offer market price. That these shareholders always gain is to be expected, of course—otherwise they would have no reason to accept the tender offer. More significant, therefore, is that companies that make tender offers experience increases in their share values of about 3 percent.[1] Because these companies are usually larger than the companies they acquire, however, the actual gain on their investment in the takeover is closer to 9 percent (above their average return before the takeover). Clearly the judgment of the market is that, on average, takeovers are likely to increase the value of both companies.[2]

These event studies have been criticized by those who believe that the stock market is an unreliable indicator of value. Both sides of the debate generally agree that hostile takeover attempts occur because the target company's stock price is "undervalued." But they disagree sharply over why it is possible for an acquiring company to offer a significant premium and yet make a profit on the investment.

Until recently, this debate had reached what seemed to be an ideological impasse. Those who believe that the stock market is a reasonably unbiased (albeit imperfect) indicator of a company's prospects at any given time argue that a company is undervalued because either the existing management is not making the best use of the firm's assets or the bidder brings new value-creating ideas or resources to bear on those assets.

Takeover critics, on the other hand, argue that the stock market systematically undervalues takeover targets because the market is increasingly dominated by institutional investors whose own performance is measured on a quarterly basis and who therefore base their analyses of corporate performance largely on short-term earnings. These critics argue that, notwithstanding the wealth increases resulting from takeover transactions, the market's alleged "short-term focus" is harmful to the economy's long-run productivity because it systematically undervalues corporations that engage in long-term planning and investments and thereby causes managers to underinvest in long-term projects. Therefore, these critics contend, stock price effects should not be used to determine the government's policy towards takeover and merger activity.

This "myopic market hypothesis" appears to be false based upon even a cursory observation of stock price behavior. First, if it were true, any new venture, especially one with no earnings history, would be unable to raise capital in the public equity markets. They do, of course, and the allegedly short-sighted institutional investors are among the principal purchasers of such offerings. Second, if the market were myopic, different companies in the same industry would not sell at different multiples of their current (or predicted near term) earnings. Unless the market is totally irrational, investors must believe that the long-term prospects of such companies differ significantly.

More important, however, three empirical studies that test the short-term hypothesis have recently been completed. First, the Office of the Chief Economist at the Securities and Exchange Commission (SEC) compared the amount of institutional ownership of, and research and development expenditures by, companies representing a cross-section of American industry with companies that were targets of tender offers between 1980 and 1983. The SEC staff discovered, contrary to the short-term hypothesis, that: (1) institutional investors not only do not shun corporations making above average research and development investments, they actually seem to prefer them; (2) takeover targets invested substantially *less* than the industry average in research and development during the years preceding the tender offer; (3) the percentage of institutional ownership of target companies was three-fifths of the percentage of institutional ownership of nontarget companies; and (4) the capital markets positively value companies that announce they are embarking on a research and development project. The staff concluded that its empirical findings appear to refute the short-term hypothesis.

Two other studies have been completed more recently by John Pound for the Investor Responsibility Research Center (IRRC). One study (using 1981–1984 data) tested the hypothesis that the increasing presence of institutional investors causes systematic undervaluation of takeover targets.[3] It examined levels of institutional ownership, size of takeover premiums, and the success of management resistance. The findings are generally consistent with the SEC staff study in refuting the alleged adverse effects of institutional investors: (1) institutional ownership is lower for takeover targets than nontargets; (2) the level of the premium paid in takeovers is unrelated to the extent of institutional ownership; and (3) the level of institutional ownership appears to have no bearing on the ability of managements successfully to resist unwanted takeovers.

The second Pound/IRRC study was designed to test the causes of the undervaluation in target companies' stock.[4] Although this study uses accounting data (for the years 1978–1984), and is thus subject to the usual criticisms of such data, it reaches much the same conclusion as the SEC staff study: there is no evidence to support the hypothesis that takeover targets have "hidden" resources that are masked by short-term earnings reports, nor is there evidence that takeover targets invest more heavily in long-term activities and are, therefore, systematically undervalued by a stock market focused on the short run. In fact, this study, like the SEC study, finds evidence that takeover targets invest *less* in long-term activities than nontarget firms.

Some takeover critics have argued that companies maintaining conservative debt levels are especially vulnerable to hostile takeovers and that such takeovers should be curtailed because they often lead to "over-leveraged" companies. The second Pound/IRRC study also tested whether takeover targets are systematically undervalued because they have less debt on their balance sheets and are thus being penalized by the market for their more cautious management. Pound discovered, however, that there is no significant difference in leverage among the control group of corporations, those involved in friendly mergers, and those taken over in hostile transactions. Indeed, targets of hostile takeover attempts were slightly more leveraged than nontargets. Remarkably, however, those companies that had successfully resisted takeovers had substantially *greater* leverage — *before* the takeover attempt — than all three of the other groups.

These three recent studies refute the hypothesis that there is a systematic flaw in the stock market valuation of takeover targets. The myopic market hypothesis is not supported in fact any more than it is in economic theory. It offers no valid reason to conclude that the wealth created by takeovers is somehow contrary to our national interest.

Accounting Studies

The only other significant empirical research that attempts to determine whether mergers or takeovers are, in the aggregate, good or bad relies on analyses of accounting data. The work of Professor F. M. Scherer of Swarthmore College and David Ravenscraft of the Federal Trade Commission Bureau of Economics is among the most recent and interesting of these efforts. Using line-of-business accounting profitability data between 1974 and 1977, they have compared lines of business that experienced substantial merger activity between 1950 and 1977 with lines that did not experience such activity. They conclude that, although profitability may be slightly higher (for mergers between "equals" and those using "pooling of interests" accounting) or slightly lower (for mergers using "purchase" accounting) in lines of business that have sustained substantial merger activity, when the premium paid to effect the merger is counted, the net effect is negative.

Accounting studies, however, particularly those that attempt to measure profitability, suffer from serious methodological problems that limit their relevance for policy purposes. For example, they do not take into account the real market values of acquired assets — only the accounting valuations, which may significantly understate their value. They generally encounter great difficulty in allocating beneficial externalities that the purchase may generate for the acquirer, such as a target's tax-loss carry-forward. Moreover, unlike the studies based on stock price data, accounting studies have not yielded consistent significant results. As a result, the interpretation and value of these studies is highly uncertain.

Anecdotal Evidence

The third category of evidence on the question whether mergers and takeovers are good or bad is the experiential and anecdotal information offered by some corporate managers and some of their investment bankers and lawyers. Notwithstanding their obvious self-interest, these people should at least be heard — they are on the industrial frontlines making the economy work, and they may know intuitively what investors, or even economists, have not yet discovered. In general, the managers object to being forced (in their view) to "waste" valuable management time and resources worrying about and defending against the possibility that someone may be able to take control of "their" business because an irrational, capricious, or short-sighted stock market has undervalued it. Institutional investors have been the prime villains, to hear these managers, although the recent empirical research by the SEC staff and Investor Responsibility Research Center should put an end to that particular bit of finger-pointing.

> *"The myopic market hypothesis is not supported in fact any more than it is in economic theory. It offers no valid reason to conclude that the wealth created by takeovers is somehow contrary to our national interest."*

Some of these merger critics express the concern that, because of stock market undervaluation, it is cheaper to buy capacity or products in the capital markets than to build or develop them in the real world—the "drilling for oil on Wall Street" lament. This phenomenon occurs primarily in industries that are undergoing significant changes due to external shocks — the oil industry (significant price declines), the telecommunications and transportation industries (deregulation), and the tobacco industry (declining demand). The decision to acquire existing oil reserves rather than engage in exploration, or otherwise to acquire real assets in the capital markets, are investment decisions, not fundamentally different from any other "make or buy" decision that businesses face every day. Nor are they any more sinister.

The ultimate object is to squeeze the most output from all available resources. Erecting barriers to takeovers on the premise that creating new assets is always "better" would be a grave error. No public interest is served when someone creates new assets at a greater cost than would be required to use existing assets. Indeed, even if the capital market's undervaluation of existing assets were irrational (and the evidence indicates it is not), economic productivity is greatest when assets flow into the hands of those who value them most. This is the best assurance that they will be put to their most productive use.

Curbs on Defensive Tactics

The only area associated with corporate takeovers that is cause for some concern is the occasional use by target company managers of defensive tactics that are not in their own shareholders' interest. The agency problem between shareholders and managers of widely held public corporations enables some managers to preserve their control, and thus their employment, at the expense of their principals. State corporation laws, which govern the relationship between shareholders and their hired managers, continue to evolve, however, in order to deal with such problems as they arise. Moreover, shareholders can protect themselves through corporate charter amendments and the contractual arrangements they enter into with their managers. Indeed, state corporation laws have accommodated rapid innovation in the last several years in order to adapt to newly possible hostile takeovers.

> *"The ultimate object is to squeeze the most output from all available resources. Erecting barriers to takeovers on the premise that creating new assets is always 'better' would be a grave error."*

While we may not agree with all of these state law developments — or every decision of the courts or of shareholder votes under them — we should be extremely reluctant to displace them with federal laws. We should prefer to solve these problems at a level closer to the problem and to the facts, preferably at the shareholder level. A federal statutory rule would be both overbroad (prohibiting activities it should allow) and underinclusive (missing some abuses, as they will continue to evolve). Unless there is convincing evidence of a serious problem of national dimension, the diversity of state law is preferable to a single federal law because it provides a laboratory for a variety of approaches and minimizes the cost of error. We have seen no such evidence of a serious problem, however.

There is also evidence that the courts are devising a more probing approach than in the past, when their unquestioning deference to managements under the "business judgment rule" appeared to give managers completely free rein to defeat unwanted tender offers. It would be entirely premature to conclude at this point that there has been a breakdown that warrants federal intervention into corporation law.

Conclusion

From the available evidence, we conclude that the market for corporate control works well. There is no market failure that should cause the government to intervene. Both economic theory and the great weight of the available evidence clearly point to a net benefit to the economy from takeover activity. While there certainly are mergers and takeovers that individually may reduce wealth rather than create it, the government is less capable of distinguishing between these two types of cases than are the private parties, who have better information and a substantial financial incentive to be right in making these judgments.

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1. Michael C. Jensen and Richard S. Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics*, vol. 11, no. 1 (1983).

2. It is worth noting that, in making this judgment, the market takes into account the transaction costs to both sides — lawyers, investment bankers, management distraction, etc. All of the costs are borne by the parties, and there are few negative externalities, so the market's private judgment is based on the same considerations as a more global social welfare judgment and is a good proxy for the "public interest" as it is affected by the takeover. The two factors that the market may not consider are: (1) the interests of adversely affected employees, including, most often, incumbent managers in hostile deals; and (2) tax consequences that the Treasury will absorb.

3. John Pound, *The Effects of Institutional Investors On Takeover Activity: A Quantitative Analysis* (Investor Responsibility Research Center, November 1985).

4. John Pound, *Are Takeover Targets Undervalued? An Empirical Examination of the Financial Characteristics of Target Companies* (Investor Responsibility Research Center, January 1986).

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The Hostile Takeover and Its Discontents

Article by Mr. Peter F. Drucker, from
THE FRONTIER OF MANAGEMENT
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Almost every week these last few years there has been a report of another "hostile takeover bid," another stock-market maneuver to take over, merge, or split up an existing publicly held company against determined opposition by the company's board of directors and management. No such wave of stock-market speculation has hit the United States since the "bears" and the "bulls" of the 1870s, when the Goulds and the Drews and the Vanderbilts battled each other for control of American railroads. The new wave of hostile takeovers has already profoundly altered the contours and landmarks of the American economy. It has become a dominant force—many would say *the* dominant force—in the behavior and actions of American management, and, almost certainly, a major factor in the erosion of American competitive and technological leadership. Yet the papers usually report it only on the financial page. And very few people, outside of business, really quite know what goes on or, indeed, what a hostile takeover really is.

The hostile takeover usually begins with a *raider*—a company or an individual who is legally incorporated and works through a corporation—buying a small percentage of the target company's share capital on the open market, usually with money borrowed expressly for this purpose. When, and as the raider expects, the target's board of directors and its management spurn his takeover bid, the raider borrows more money—sometimes several billion dollars—buys more of the target's shares on the market, and goes directly to the target's stockholders, offering them substantially more than the current share price on the stock exchange. If enough of the target's shareholders accept to give the raider complete control, he then typically unloads the debt he has incurred in the takeover onto the company he has acquired. In a hostile takeover the victim thus ends up paying for his own execution.

The raider not only now controls a big company: he has made a tidy profit on the shares he bought at the lower market price. Even if the takeover attempt fails, the raider usually wins big. The target may only be able to escape the raider by finding a *white knight,* that is, someone who is less odious to the management of the target company and willing to pay even more for its shares, including those held by the raider. Alternatively, the target company pays ransom to the raider—which goes by the Robin Hood–like name of *greenmail*—and buys out the shares the raider acquired at a fancy price, way beyond anything its earnings and prospects could justify.

Hostile takeovers were virtually unknown before 1980. Harold Geneen, who built ITT into the world's largest and most diversified conglomerate in the 1960s and 1970s, made literally hundreds of acquisitions—perhaps as many as a thousand. But he never made an offer to a company unless its management had first invited him to do so. Indeed, in a good many of Geneen's acquisitions the original initiative came from the company to be acquired; it offered itself for sale. In those days it would have been impossible to finance hostile takeovers: no bank would have lent money for such a purpose. But since 1980 they have become increasingly easy to finance.

At first, hostile takeovers were launched by large companies intent on rapid growth or rapid diversification. This phase reached a climax in 1982 with a months-long battle of three giants: Bendix (defense and automotive), Martin-Marietta (defense, aerospace, and cement), and Allied (chemicals). Bendix began the fight with a hostile takeover bid for Martin-Marietta, which promptly counterattacked with a hostile takeover bid for Bendix. When these two, like two scorpions in a bottle, had finished each other off, Allied joined the fray, paid ransom to an exhausted Martin-Marietta, took over Bendix, and in the process ousted the Bendix management that had started the battle.

Since then, raiders increasingly are individual stock-market operators whose business is the hostile takeover. Some, like Carl Icahn, range over the lot, attacking all kinds of business. T. Boone Pickens, originally a small, independent oil producer, specializes in large petroleum companies—his targets have included such major companies as Gulf Oil, Phillips Petroleum, and Union Oil. Ted Turner of Atlanta specializes in the media and was embroiled in a hostile takeover bid for the smallest of the three television networks, CBS. But there are dozens of smaller raiders abroad, many of them looking for fast-growing medium-size companies, especially companies in such currently "sexy" fields as electronics, computers, or biotechnology. Others primarily raid financial institutions. Practically all of them do so on money borrowed at high interest rates.

➤ *Why the Raider Succeeds*

How many hostile takeover bids there have been, no one quite knows. Conservative estimates run to four hundred or five hundred, with at least one-half ending in the disappearance of the target company either because the raider succeeds or because the target finds a white knight. Such a massive phenomenon—whether considered destructive or constructive—surely bespeaks fundamental changes in the underlying economic structure and the environment of American business and the American economy. Yet to my knowledge there has so far been practically no discussion of what might explain the takeover phenomenon, of its meaning, and of the policy questions it raises.

What, for instance, explains the *vulnerability* of companies, among them a good many big, strong, well-established ones? Few of the raiders have much financial strength of their own. Most have little managerial or business achievement behind them. In the 1960s and early 1970s, the managements of big, publicly owned companies were widely believed to be impregnable; nothing short of the company's bankruptcy could threaten, let alone dislodge, them. It was then considered almost a "self-evident truth" in highly popular books (those of John Kenneth Galbraith, for instance) that we had moved into "corporate capitalism" as a new and distinct "stage," one in which professional managers perpetuated themselves and ran the country's big business autonomously, ruling without much interference from any of their supposed "constituencies." But in the last few years, any number of companies, and particularly large companies doing well by any yardstick, have been swallowed up by hitherto unknown and obscure newcomers despite the most vigorous defense by their management.

These raiders often have no capital of their own, but have to borrow every penny they need to buy a small percentage of the company's stock and then to make their takeover bid. By now, to bar a hostile takeover bid even giants like General Motors are forced into expensive and complicated subterfuges such as splitting their shares into a number of different issues, each with different voting rights. What has happened to corporate capitalism and to the absolute control by professional autonomous management, seemingly so firmly established only a little while ago?

Fundamentally, there are three explanations for this extreme vulnerability of established companies to the hostile takeover.

One explanation is inflation.

Then there are structural changes within the economy that make a good many of yesterday's most successful companies no longer appropriate to today's economic realities.

Finally, *corporate capitalism*—that is, the establishment of a management accountable only to itself—has made managements and companies exceedingly vulnerable. They have no constituencies to come to their succor when attacked.

Inflation distorts: It distorts values. It distorts relationships. It creates glaring discrepancies between economic assumptions and economic realities. The fifteen years of inflation in America which began during Lyndon Johnson's presidency and continued into the early 1980s were no exception. And the most predictable, indeed the most typical, distortion of inflation is between the value of assets and their earning power. *In any inflation the cost of capital goods tends to rise much faster than the price of the goods they produce. It thus becomes economical to buy already existing capital assets rather than to invest in new facilities and new machines.* So any company that is rich in fixed assets is worth more when dismembered—that is, when its capital assets are being sold as pieces of real estate, as factories, as machinery and equipment—than it is worth on a realistic price/earnings ratio based on the value of its output. This is one of the distortions that the raiders exploit.

The stock market values companies on the basis of their earnings. It values them, in other words, as "going concerns." It does not value them on their liquidation value. As a result, a company heavy with fixed assets—and especially a company that also has a lot of cash with which the raider, after the takeover, can repay himself (and make a sizable profit to boot) —becomes a most inviting target. This situation accounts for one-quarter, perhaps even one-third, of all the successful hostile takeovers.

Equally important are the tremendous structural changes in the American and world economies in the last fifteen years. They have made inappropriate a good many of the traditional forms of economic integration. The best example is probably the large, integrated petroleum company. One need not sympathize with Mr. T. Boone Pickens, the raider who successfully forced one of the country's largest and proudest petroleum companies, Gulf Oil, into a shotgun marriage with a white knight and almost succeeded in taking over two other old and well-established petroleum companies, Union Oil and Phillips. But Pickens has a point. He has forced the petroleum companies at which he leveled his guns to do something sensible: that is, to split the company into two parts, one making and selling petroleum products, one keeping reserves of crude oil in the ground.

Large integrated petroleum companies have performed poorly since 1980 or 1981. Their earnings basically reflect a crude oil price of around $12 or $15 a barrel, which is what the market price would have been all along had there been no OPEC cartel. But all of them have tried desperately, since the OPEC oil shock of 1973, to build up underground crude oil reserves for the future. And these reserves were priced in the market, and especially by people looking for a long-term tax shelter, on the expectation of a petroleum price many times the present price, twenty or thirty years hence. In fact, to justify what the market was paying for crude and crude oil reserves in the ground, one would have to assume a petroleum price of around $100 a barrel by the year 2015 or so; otherwise, on a discounted cash-flow basis, the present valuation of these proven underground reserves could not possibly be justified.

Whether the expectation of high petroleum prices twenty or thirty years hence is rational is not the point. (Every historical experience would indicate that the only rational expectation is for the petroleum prices thirty years hence to be lower than they are today—but this is another issue.) The fact is that it makes little sense today to be an "integrated" petroleum company. The interests of the people who want the earnings of the present petroleum company, and the interests of the people who look for a long-term tax shelter (and who, in other words, do not care much about present earnings), are not compatible. Therefore Pickens's proposal, that the integrated petroleum company split itself into two pieces, made sense.

A similar situation exists in the steel industry, and in fact in a good many of the traditional large-scale, integrated, capital-intensive materials producers. Every one of these situations invites a raider.

But perhaps the biggest single reason companies are vulnerable to the raider is "corporate capitalism" itself: that is, autonomous management, accountable to no one, controlled by no one, and without constituents. It has made management arrogant. And far from making management powerful, corporate capitalism has actually made it impotent. Management has become isolated and has lost its support base, in its own board of directors, among its own stockholders, and among its own employees.

Wherever a management threatened by a raider has been able to organize a "constituency," it has beaten off the hostile takeover. One example is Phillips Petroleum in Bartlesville, Oklahoma, which mobilized the employees and the community; this was enough to defeat Pickens. But where managements have given in to the temptation to become omnipotent they have in effect rendered themselves impotent. When they are then attacked, they have nobody to support them if someone offers a few dollars above the current market price to the company shareholders.

➤ *Where the Cash Comes From*

The vulnerability of the victims does not, by itself, explain how the raiders finance their takeover. To mount a hostile takeover bid for a large company takes a very large war chest. One and a half billion dollars is just about the minimum needed to attack a big company. In some recent cases the amount went up to $4 billion. It has to be in cash, as a rule. To be sure, if the takeover bid succeeds, the target company then pays. But the money has to be available from the beginning—that is, when it is by no means sure that the takeover bid will succeed. If the takeover bid is launched by an individual, as more and more of them have been in recent years, there usually is no security whatever for the cash that the raider has to borrow.

The raider himself usually has negligible assets, certainly compared to the sums needed. Even if the takeover bid is being launched by another large company, the amount needed to finance it is usually way beyond anything the company could normally raise as additional debt. *Yet the only "security" for the loan that a raider has to obtain is the promise of repayment if the raid is successful.* This is hardly what was once normally considered a "bankable" loan, yet the raiders have had no difficulty obtaining these loans. Indeed, when the financing of hostile takeover bids switched (mostly for regulatory reasons) from being done by means of bank loans to being done by means of bonds, the market promptly named the bonds *junk bonds,* and with good reason. Nevertheless, there is no difficulty in getting such bonds underwritten and issued, with commercial banks being avid buyers.

Bank loans—or junk bonds—to finance hostile takeovers are available for the same reason that enabled countries like Brazil, Zaire, or Argentina, in the early 1980s, to obtain loans from Western banks in amounts that were clearly beyond their capacity to pay interest on (let alone to repay the loan itself), and for the same reason that large money-center banks, such as Continental Illinois in Chicago, were willing, indeed eager, to snap up highly speculative and sometimes fraudulent loans often to nonexistent oil and gas speculators. *The American commercial bank is pinched by the shrinkage of its traditional sources of income and almost desperate to find new ones, and especially to find borrowers willing to pay very high interest rates.* And the raider who makes a hostile takeover bid is, of course, perfectly willing to promise very high interest rates; after all, he will not pay them—the company he is aiming to take over will, after it has succumbed.

Commercial banks, as every textbook states, make their living as *liquidity arbitrageurs*: They obtain their money from "demand deposits" which have perfect liquidity—that is, the right to withdraw the money at any time. The bank then lends out that money for longer periods of time (from ninety days to three years is the ordinary time span of a commercial loan); so the amounts owed to the bank have far less liquidity than the amounts it owes. This, then, justifies the bank's charging a substantially higher interest rate, with the difference between the interest rate on what the bank lends out and the interest rate on what the bank borrows being the bank's income.

Increasingly, this does not work anymore, for the bank either is not able to be the liquidity arbitrageur or does not get paid for it. One reason is, of course, that zero-interest demand deposits, once prescribed by the regulatory authorities, have all but disappeared. Historically, businesses have provided the bulk of the demand deposits. But few businesses these days keep large cash supplies, and the typical checking account of individuals now pays 5.5 percent interest. Adding to this the costs of administration, acquisition, and so on, the bank probably ends up paying 8 or 9 percent for the money on deposit in customers' checking accounts—which means that even demand deposits no longer provide a substantial "interest spread." And most American consumers today keep in their checking account only a minimum balance. The rest is in accounts that pay much higher interest, such as money-market accounts, which still allow high liquidity.

On the demand side, too, the liquidity arbitrage has become far less profitable. Increasingly, American businesses do not finance themselves through commercial loans, but through *commercial paper*—the business version of an installment loan. This, however, bypasses the banking system. The company with a temporary cash surplus directly buys commercial paper issued by another company with a temporary cash need. But the "spread" on commercial paper between what the borrower pays and what the lender gets is much lower than that between the traditional noninterest on demand deposits and the bank's lending rate on commercial loans. That spread may be 1.5 percent as against 4 or 5 percent previously.

By now, most U.S. banks, especially the larger ones, know that they cannot hope to continue to build their business on the "spread" of interest rates between what they pay for their money and what they charge for it. They will have to shift their income base to fees and commissions. But even those few banks which accepted this ten years ago and which since then have been working hard on shifting their source of income from being paid for money to being paid for information and service —Citibank in New York was probably the first, and is by far the leader—still have a very long way to go. And in the meantime the banks are hurting for sources of income. Hence the pressure on them to look for borrowers willing to pay higher interest—or at least to promise they will—whether they be Oklahoma wildcatters, military governments engulfed by inflation in their own country (such as Brazil and Argentina), or takeover raiders.

> *The Lure of Easy Money*

That the raiders can obtain money they need still does not explain why the shareholders team up with the raider to take over, merge, or liquidate the company they own.

They do not do so, it is abundantly clear, because they believe the takeover will be advantageous to the company. On the contrary, the shareholders clearly know that the takeover bid is usually a disaster for the company. Increasingly, they sell their shares to the raider only if they get cash, that is, if they get out of the company and have nothing to do with it anymore. Or, if they take securities in exchange, they immediately sell them. And yet, again and again, the shareholders, in their great majority, either accept the bid of the raider or turn it down only if a white knight offers more than the raider does. But then they also immediately sell whatever the white knight has given them in exchange against their holdings in the company that has disappeared.

The shareholders who control our large, publicly held companies simply have no choice but to accept the raider's offer. They are forced, perhaps even legally forced, to accept the raider's bid if it is higher than the currently quoted price for the stock. This is essentially a result of the shift of share ownership from individuals to institutions who are "trustees," and especially to pension funds. Pension funds (increasingly also mutual funds) are the legal "owners" of the publicly owned companies of America, with their holdings amounting to about 50 percent of the common shares. The percentage is even higher for large companies because the institutional holders concentrate on them. The people who manage these large and growing aggregations of capital, especially the pension fund managers, are trustees rather than owners. They are trustees both for the management of the companies which owe the pensions to their employees and for the ultimate beneficiaries, the employees and future pensioners. As trustees they have, however, little choice about whether they want to sell their shares if someone bids substantially above what the same shares fetch at the market price. They have to accept. If they were to say no, they would lay themselves open to an enormous and uninsurable liability. The trustees could be sued by both the management of the company and the ultimate beneficiaries, the employees, were those shares, six months later, quoted below the price the raider had offered. Trustees do not have the right to superimpose *their* judgment on what a "prudent man" would do. And a prudent man surely will take the bird in the hand, especially if there is no reason to believe that there is a bird in the bush.

Pension fund managers are also under tremendous pressure to show better-than-average returns—and yet are unable to do so as a rule. The pension funds of most American businesses are *defined-benefit* plans: The company promises to pay the employee upon retirement a fixed proportion of the employee's salary, usually 60 percent or so of the last five years' earnings. What the employee is to receive is fixed, or rather will be fixed by the time the employee reaches retirement. What the company contributes, however, is flexible. The contribution payable by the company goes down if the pension fund increases in value—if, for instance, it shows a high return or profit from its investments. If the pension fund does not show earnings, or shows earnings lower than anticipated, the company's contribution goes up.

This is in sharp contrast to plans based on a *defined contribution,* under which what the company pays in each year is fixed, with the employee upon retirement receiving either a fixed stipend or a variable one which depends upon what the earnings of the pension fund have been.

In the defined-benefit plan, therefore, management constantly pushes the pension fund manager to show profits, especially from investments, so that the company's contribution can be minimized. But this is a total delusion. It is in fact an impossibility. The pension funds by now *are* the American stock market. And if one is the market, one cannot possibly beat it. The performance record of the pension funds bears this out. It has been abysmal, almost without exception. In fact, the desire to "beat the market" is in itself the reason that most pension funds have performed substantially worse than the market. As a result, the pension funds waste their substance by supporting a huge stock market that only fritters away in commissions the money that should go to the future beneficiaries. In the long and checkered history of investment and finance, there is probably no more uniformly dismal record than that of American pension fund management in the last twenty years.

And yet company managements still believe that their fund can "beat the odds"—the way each slot machine player in Las Vegas believes that he can beat them. And the pension fund manager who does not operate short term, and who refuses to speculate, to trade, and to show "results" over the next three months, is likely to lose the account quickly. There is probably no more competitive industry around. This makes irresistible an offer by the raider to pay $55 for a share that is quoted at $40 on the market.

Pension fund managers know that the raider's bid is deleterious to the company whose stock they own. But they cannot consider the welfare and interests of their "property." They are not owners. They are of necessity speculators, even though they are legally vested with the owner's power. And so they behave as speculators. They have to accept the raider's bid unless a white knight makes a better offer.

> *The Dangers of Defensiveness*

The wave of hostile takeovers is a result of profound structural changes in the American economy. But it is in itself a serious disorder. There is a great deal of discussion about whether hostile takeovers are good or bad for the shareholders. There can be absolutely no doubt, however, that they are exceedingly bad for the economy. They force management into operating short term. More and more of our businesses, large, medium-size, and small, are not being run for business results but for protection against the hostile takeover. This means that more and more of our businesses are forced to concentrate on results in the next three months. They are being run so as to encourage the institutional investors, on which all publicly traded companies today depend for their supply of capital, to hold onto the company shares rather than to toss them overboard the moment the first hostile takeover bid appears.

But worse still, companies are being forced to do stupid things to prevent themselves from being raided. It is, for instance, becoming dangerous for any company to be liquid. Liquidity can only attract the raider who can expect to repay himself, and the debt he incurs in bidding for the company, out of the company's own cash. And thus companies who find themselves in a liquid position, no matter how much cash they may need only a few months further on, hasten to squander the cash—for instance, in buying up something that is totally alien to their own business and has only one advantage: it absorbs a lot of money. Even worse, companies increasingly cut back on expenses for the future, such as research and development. One of the most ominous developments for the future of America is the speed with which the Japanese are taking over the markets of the rapidly industrializing countries: Brazil, for instance, or India. They do so because they can invest in the distribution system in these countries in anticipation of the future market. American company managements are perfectly aware of this. But when asked why they do not do likewise, they tend to say, "We cannot afford to set aside this money and invest it in tomorrow. We need it to make a good showing in next month's or next quarter's profits."

The fear of the raider is undoubtedly the largest single cause for the increasing tendency of American companies to manage for the short term and let the future go hang. The fear of the raider demoralizes and paralyzes. The impact on the morale of management people and of professional people in the company can hardly be overestimated. And worse still, after the successful takeover, the morale in a company is destroyed, often forever. The people who can leave, do. The others do their minimum. "What's the point in my trying to do a good job if the rug will be pulled out from under me tomorrow?" is a frequent comment. Add to this that the raiders, in order to reimburse themselves, usually start out by selling off the company's most promising businesses. Hence the impact of a takeover on morale is total catastrophe.

Altogether, the record is poor for all companies that have been merged, especially into a conglomerate or into a business with which they had little in common: for example, the typical financial conglomerate. Only three out of every ten such acquiring companies do as well two years later as they did before the merger. But the record of companies that have been acquired in a hostile takeover is uniformly dismal.

Clearly the hostile takeover cannot be justified as leading to a more efficient allocation of resources. Most of them have no aim except to enrich the raider. To achieve this end, he offers the stockholders more money for their shares than they would get on the market, which is to say, he bribes them. And to be able to pay the bribe he loads a heavy debt on the company that is being taken over, which by itself severely impairs the company's potential for economic performance. The fact that, almost without exception, the result of the hostile takeover is also a demoralization and severe impairment of the human organization disproves the argument that the hostile takeover results in a more efficient allocation of resources. Actually, all it proves is that "resources" in the modern business enterprise are not primarily bricks and mortar—or even oil in the ground. They are the human organization.

There are indeed cases where a human organization becomes more productive by being dissociated from its former enterprise, by being set up separately—in fact, a good many of today's large organizations, and especially the conglomerates, would greatly increase their productivity by being split into smaller units, or by establishing parts as separate businesses. But this is not what the hostile takeover accomplishes. On the contrary, the most valuable parts of the acquired business are invariably put on the block after a hostile takeover so as to raise money to pay off some of the debt. And this impairs both their productivity and that of the remaining assets.

There are serious questions about resource allocation in the American economy. But the hostile takeover is clearly not the right tool to bring about a more efficient allocation. It does severe damage to the true productive resource, the human organization, its spirit, its dedication, its morale, its confidence in its management, and its identification with the enterprise that employs its people.

Even if hostile takeovers are "good for the shareholders"—and they are "good" only for the very shortest time—they are surely not good for the economy. They are indeed so bad that we will be forced to put an end to them, one way or another.

One way to do so might be to emulate the British and create a "takeover panel" with the power to stop takeover bids considered to be contrary to the best long-term interest of the enterprise and the economy. Whether such a panel could be set up in this country—or whether it would just become another troublesome government agency—is very debatable. The way the British are doing it would immediately run afoul of our antitrust laws.

It is therefore more probable that we will put an end to the hostile takeover—or at least put serious obstacles in its path—by abandoning the concept of "one share, one vote" and go to shares that, although participating equally in profits (and in the proceeds of a liquidation), have unequal voting power, at least as long as the company shows adequate financial results. General Motors has already gone this way, and quite a few smaller firms are following. This would not be a radical departure. The British, for many years, had the *private limited company,* in which management held the voting power as long as it showed specified results. Similarly, the Germans, for well over a hundred years, have had the *Kommanditgesellschaft auf Aktien,* in which management holds the majority of the voting power even though it has a very small minority of the share ownership—again, as long as there is adequate performance and results. In other words, a shift to a system in which different classes of shares have differential voting power—with Class A shares, for instance, having one hundred times the votes of Class B shares—would only need a few fairly simple safeguards to be functional: One, vesting the Class A shares, with their superior voting power, in a truly independent and strong board of directors rather than in management, a board on which independent outside directors have a clear majority (which is what the Germans require, by the way). Second, making the extra voting strength of the Class A shares conditional on the company's showing specified results and adequate performance. Thus a two-class system of shares would control the hostile takeover and yet give protection against managerial malperformance and even against managerial mediocrity.

But perhaps the takeover wave will come to an end with a whimper rather than a bang by losing its financial underpinnings. It would not take much to bring this about. One default on one big loan to finance a hostile takeover, one "billion-dollar-scandal" similar to the Penn Square collapse in Oklahoma that brought down Chicago's mighty Continental Illinois Bank—and there would be no more money available to finance hostile takeovers. And in the long history of finance, every single scheme that lured lenders into advancing money for economically nonproductive purposes by promising them returns substantially above the going market rate has come to a bad end sooner or later—and usually sooner.

Even if we control the hostile takeover, however, there will remain the underlying structural problems of which the hostile takeover is only a symptom. It clearly raises basic questions about the following: the role, functions, and governance of pension funds; the legitimacy of management; and finally, the purpose of business enterprise, especially large enterprise. Are the stockholders the *only* constituents to whom all other interests, including that of the enterprise itself as a going concern, must be totally subordinated?

> *Where Wall Street Meets Las Vegas*

Abatement of the boom in hostile takeovers can, paradoxically, only aggravate the pension fund problem. It would eliminate the windfall profits pension funds now reap by accepting the inflated prices the raider offers. These windfall profits are, by and large, the only way for pension fund managers to obtain the quick stock-market gains that their bosses, the company's managers, expect and demand of them. If they are eliminated, company managers will predictably put even greater pressure for quick results on the people who manage their company's pension fund; and those in turn will put even greater pressure for short-term results on the companies in the shares of which the fund invests—thus pushing businesses even further toward managing for the short term, which, as by now everybody agrees, is a significant factor in the steady erosion of America's competitive position in the world economy. As long as American pension funds are based on "defined benefits," no relief is in sight.

It might have made sense for the labor unions to push for defined benefits when pension funds first became widespread some thirty years ago. For under that system, the employer shoulders all future risks. Actually, in the negotiation of the contract that set the pattern for today's pension fund, the General Motors contract in the spring of 1950, the United

Automobile Workers strongly opposed defined benefits and wanted "defined contributions" instead.* It was the company that chose defined benefits, even though General Motors' president at the time, Charles E. Wilson, recommended a defined-contributions plan as financially much sounder. He as well as Reuther were, however, overruled by GM's finance committee, and the rest of the country's pension plans then followed GM's lead. Yet the choice of defined benefits—as we now realize, a major blunder—was based on the same delusion that makes people in Las Vegas believe that they will "make a fortune" if only they keep on feeding more quarters into the slot machine.

Under defined benefits the company commits itself to paying the future pensioner a fixed percentage of his wage or salary during his retirement years. The contribution the company makes is then dependent on the value of the fund's assets in a given year, as against the present value of the future pension obligation. The higher the fund's present value the lower the current contribution, and vice versa. And so management deluded itself into believing that an an ever-rising New York stock market is a law of nature—or at least of history—and that, therefore, under a defined-benefits plan, it would be the stock market, through its preordained continuing rise, that would eventually provide the money to discharge the pension obligation rather than the company itself. Indeed, quite a few managements then promised their boards of directors that the defined-benefits plan would in the long run become a "money spinner" for the company and would produce income well above anything it would have to put into the plan.

And then the second delusion: Practically every company adopting a defined-benefits pension plan did so with the firm belief that its own pension plan, if only administered "professionally," would "beat" *even* an ever-rising market.

*I had occasion to discuss this issue repeatedly with Walter Reuther, then head of the UAW, when the contract was under negotiation. Reuther feared, groundlessly as it turned out, that "defined benefits" would make the worker conscious of the identity of interest between himself and the employer and thus alienate him from the union.

There is, of course, no law that prescribes an ever-rising stock market. Stock markets historically have not even been particularly effective as hedges against inflation: The American market in the last twenty years, for instance, barely kept pace with it. Indeed a large pool of money which over any long period of time grows at all, let alone as fast as the economy, is the rarest of all exceptions—neither the Medici nor the Fuggers, nor the Rothschilds nor the Morgans, succeeded in this endeavor. Similarly, no large-company pension fund, to the best of my knowledge, has over the last twenty or thirty years done as well as the stock market. The only performance that counts in the pension fund is performance over the long run, because the obligations extend over twenty-five years or longer. Indeed, some of the large defined-contributions funds have produced better results for their beneficiaries, the employees and future pensioners, and at lower cost to the employers, than the great majority of the large defined-benefits plans. This is most definitely true of the largest of the defined-contributions plans, that of the employers and employees of the American nonprofit institutions, the Teachers Insurance and Annuity Association.

The misconceptions that led American management into opting for defined benefits thus practically guaranteed from the beginning that the funds would have to become "speculators" and increasingly short term in their focus.

The choice of defined benefits also explains in large part the poor *social* performance of the American pension fund. For it was conceived, as Walter Reuther quite rightly suspected, as much to be a social as to be a financial institution. It was conceived to create a visible center of common interest between employer and employee. Indeed, what General Motors had in mind was very similar to what the Japanese, acting quite independently a few years later, achieved by "lifetime employment." But unlike lifetime employment the American pension fund has not created any community of interest in the worker's mind.

The laws that govern the private pension plans in America define their managers as "trustees" for the eventual beneficiaries, the employees. In reality the managers of defined-benefits plans are of necessity appointed by and accountable only to company management. For the one at risk is the employer—and so the fund has to be run to reduce, as much as possible, the burden on the employer. As a result, the employees feel no responsibility for the fund. It is "deferred wages" rather than a "stake in the company." The employees do not feel that it makes any difference how the fund performs. And they are right: Unless the company goes bankrupt it does not make any difference to them. They also, in a defined-benefits plan, cannot in any meaningful way be brought into the decision-making process through the pension fund, the actual owners of America's productive resources.

A defined-contributions plan is no panacea, but it minimizes the problems. The right model was easily available thirty years ago—for the Teachers Insurance and Annuity Association goes back much further, to the early 1920s. The TIAA runs on "flexible contributions" rather than on defined contributions. The contribution made each year into the plan by a university, or a nonprofit organization such as the Boy Scouts, or for a minister in a Protestant denomination, is a fixed percentage of salary. It goes up as the employee advances. It thereby also—an important point—automatically adjusts the annual contribution to inflation. And yet this annual premium is known and predictable. And because of this, the TIAA can, and does indeed, invest for the long term, which in turn explains why its results have been better than those of any of the large defined-benefits plans. At the same time, the TIAA, precisely because the employer has discharged his obligation in full once he remits a fixed percentage of the employee's salary, has been able to bring the future beneficiaries, that is, today's employees, into the government of the institution. University faculty do not consider the TIAA the "employer's pension fund"; it is "our pension fund," in which they take an active interest and which to them meaningfully symbolizes the basic identity of economic interest between their employer, that is, the university, and themselves.

Pension plans are beginning to change, albeit very slowly. Many companies, especially medium-size ones, now encourage employees to make their own pension provisions, often out of company-provided funds, for example, through an Individual Retirement Account. That at least makes possible a rational (that is, a long-term) investment policy. But for the foreseeable future the bulk of our corporate pension plans will remain committed to the defined-benefits formula. The principal legal owners of our large companies, the large pension funds, will therefore continue to be forced to act as speculators rather than as investors, let alone as owners. And thus there will, for the foreseeable future, be a need to protect the economy's wealth-producing resources—that is, its businesses, and the pension funds themselves—against the pressure to manage for the immediate, the short term, the next month, the next quarter, and above all against the takeover.

➤ *Demise of the Corporate Guardians*

Corporate capitalism—the rule of autonomous managers as the "philosopher-kings" of the modern economy accountable at best to a professional code but not controlled by shareholders or by any other constituency—was first proclaimed more than fifty years ago by Adolph Berle and Gardner Means in their 1932 classic, *The Modern Corporation and Private Property*. "Control," Berle and Means argued, had become divorced from "property." Indeed, property was no longer ownership. It had become investment, concerned only with dividends and capital gains but not with the welfare or the governance of the property itself.

From the beginning, anyone with any knowledge of political theory or political history could have predicted that this would not work. Management, one could confidently say, would not last any longer as philosopher-king than any earlier philosopher-kings had, which was never very long. Management has power. Indeed, to do its job, it *has* to have power. But power does not last, regardless of its performance, its knowledge, and its good intentions, unless it be grounded in some sanction outside and beyond itself, some "grounds of legitimacy," whether divine institution, or election, or the consent of the governed. Otherwise, power is not legitimate. It may be well-meaning, it may perform well, it may even test out as "highly popular" in surveys and polls. Yet illegitimate power always succumbs to the first challenger. It may have no enemies, but no one believes in it, either, and no one owes it allegiance.

This should have been obvious to American management fifty years ago when Berle and Means first pointed out that there was no more real ownership in the American corporation. After all, that the philosopher-king—that is, power grounded in performance rather than in legitimacy—would not last had been known since Aristotle's dismissal of Plato's philosopher-king, all of twenty-three hundred years ago. But American management did exactly what all earlier philosopher-kings have done—for example, the "enlightened despots" of eighteenth-century Europe. It gloried in its good intentions. And American managements busily engaged in removing what they considered as the last obstacle to their enlightened rule, an independent and powerful board of directors. And then, when the investors of Berle and Means became the speculators of the pension fund, management found itself powerless against the first challenger, the raider. The hostile takeover bid is thus the final failure of corporate capitalism.

But we do need management. The business enterprise needs a government, and it needs a government that has power, has continuity, and can perform. In other words, it needs a government that has legitimacy. How can legitimacy be restored to the management of America's large, publicly owned companies?

One step, surely the first one, is to restore an independent and strong board of directors. Indeed, as has already been pointed out, where such a board exists, raiders, by and large, have been beaten off. Even shareholders whose only interest is the quick buck are likely to listen to a strong and independent board that has standing and respect in the community and is not dismissed as management's puppet. The hostile takeover may thus finally succeed in bringing about the reform and restoration of the strong, independent board of directors which a great many voices within the business community have been demanding for many years.

But such a board would not and could not be a representative of the shareholders alone. The board member who commands enough respect to be listened to is likely to be an *independent director,* that is, somebody who does not represent any constituency, including the nominal owners, but rather the integrity and the interest of the enterprise itself. The hostile takeover is thus almost certain to speed up a development that is already under way: the emergence of professionally qualified men and women who serve on a very small number of boards, maybe no more than four at a time; who have independent respect and standing in a broader community based on their achievements and known integrity; and who take seriously their responsibilities, including the responsibility to set performance goals for top management and to police them, to monitor the behavior and ethics of top management, and to remove even the proudest chief executive officer who does not live up to the standards set by the board in the interest of the enterprise.

But is this not simply replacing one set of philosopher-kings by another group of technocrats or wise men? To be sure, independent outside board members, unlike a company president, do not fight for their own jobs when they resist a takeover. But they still do not represent any identifiable constituency, neither do they have any grounds of legitimacy other than disinterested performance and knowledge. Will the large public corporation in America have to learn to mobilize new constituents, to bring in other "interests" to balance the former owners now become speculators, and to create new bonds of allegiance?

Reportedly, would-be raiders refrain from making a hostile takeover bid for a company in which employees hold a substantial portion of the shares. They know that employee-owners are not likely to accept the raider's offer. Most employees stand to lose more, of course, if their jobs are endangered than they can possibly gain by getting more for their stock. Above all employees identify with the company and are personally and emotionally attached to its remaining independent. And the most spectacular defeat of a hostile takeover bid was not achieved by a management with a strong performance record. It was the previously mentioned defeat of the bid for Phillips Petroleum in Bartlesville, Oklahoma, when the town itself rallied to the defense of its major employer.

Thirty years ago it was popular in American big business to talk of management as being the "trustee for the best-balanced interests of stockholders, employees, plant community, customers, and suppliers alike." In many cases, of course, this was pure phrase meant to clothe with respectability the managerial philosopher-king and his enlightened despotism. But even where there was more to this assertion than self-interest, nothing has been done as a rule to convert the phrase into reality. Few attempts have been made to institutionalize the relationship of these supposed "constituencies" to the enterprise and its management. Will this now have to be undertaken in earnest to safeguard both enterprise and management? And what form should such institutional relationships take?

> *The Challenge to Free Enterprise*

The question being most hotly debated currently is whether hostile takeovers are good or bad for shareholders. But what other groups may have a legitimate stake in the fight for the control and survival of the enterprise is probably more important, though less discussed. Does the modern, publicly owned, large enterprise exist *exclusively* for the sake of the shareholders? This is, of course, what orthodox "capitalism" asserts. But the term *free enterprise* was coined forty or fifty years ago to assert that the shareholder interest, although important, is only one interest and that the enterprise has functions well beyond that of producing returns for the shareholder—functions as an employer, as a citizen of the community, as a customer, and as a supplier. The British, in establishing a "take-over panel," have expressly recognized that a decision on mergers and takeovers affects the public interest. So far in the United States, this is expressed only negatively, that is, in forbidding mergers that violate antitrust laws. Will we have to bring in considerations of the impact on other groups and on the community and economy as a whole—and in which form? That is the central question. The answers this country will give to it will largely define the future shape of the American economy.

If the answer is, however, that the speculator's interest—never mind that the speculator has legal title as an owner—is the only interest to be considered, the free-enterprise system is unlikely to survive. It will rapidly lose public support. For most people, even though they do benefit—however indirectly (that is, as ultimate beneficiaries in a pension fund)—from the speculator's game, stand to lose more from the hostile takeover as employees, whether blue-collar or managers, and as citizens of a community. And more and more people are concerned with the hostile takeover as a moral issue. It deeply offends the sense of justice of a great many Americans.

Most Americans today are employees of an organization. There is a good deal of evidence that people in an organization, and especially managerial and professional people, will accept even the most painful adjustment, such as the closing of a business or the sale of parts of it, if the rationale is economic performance or the lack thereof. But this of course is not the rationale for the purchase or sale of the human organization or of its parts in the hostile takeover. There the only rationale is to enrich somebody who has nothing to do with the performance of the enterprise and who, quite admittedly, has not the slightest interest in it. And this goes against the grain of employees who feel that the hostile takeover treats them as "chattel" and not as a "resource," let alone as human beings. "Is the hostile takeover even compatible with our laws against peonage and involuntary servitude?" the middle-level executives in my advanced-management classes have been asking me of late.

Almost a hundred years ago the United States decided that the rights of the creditor are not absolute and amended its bankruptcy laws to put maintenance and restoration of the "going concern" ahead of the rights of the creditor, which till then had ruled when a business got into difficulties. This has worked remarkably well. The protection of the going concern during reorganization has indeed proved to be in the ultimate interest of the creditor, too. Will we now do the same thing with respect to the hostile takeover and give consideration to the protection of the going concern as a resource, and to the interests of employees, whether blue-collar, white-collar, or managerial; of the community; of suppliers and customers? Actually we are already moving in this direction through extending the protection of the bankruptcy laws to nonbankrupt going concerns threatened by subjection to one single interest. The Johns-Manville Corporation—a leading producer of asbestos and other building materials—successfully invoked the bankruptcy laws to preserve itself as a going concern and to protect its shareholders and its employees against a tidal wave of asbestos-damage liability suits. Continental Airlines similarly used the bankruptcy laws successfully to preserve itself against union wage claims that had become unbearable when deregulation made airfares and airline routes hotly competitive. It is by no means inconceivable that a clever lawyer will similarly construe the bankruptcy laws to preserve the going concern against the hostile takeover—and that the courts will go along as they did in the Johns-Manville and Continental Airlines cases. But one way or another—by law, by moving to multitier stock ownership, or by judicial exegesis—we surely will find a way to protect the going concern against hostile takeovers that subordinate all other interests—employees, the enterprise's long-range growth and prosperity, and the country's competitive position in an increasingly competitive world economy—to short-term speculative gain.

[1986]

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The Takeover Controversy: Analysis and Evidence*

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Introduction

The market for corporate control is fundamentally changing the corporate landscape. Transactions in this market in 1985 were at a record level of $180 billion, 47 percent above the $122 billion in 1984. The purchase prices in 36 of the 3,000 deals exceeded a billion dollars in 1985, compared with 18 in 1984.[2] These transactions involve takeovers, mergers, and leveraged buyouts. Closely associated are corporate restructurings involving divestitures, spinoffs, and large stock repurchases for cash and debt.

The changes associated with these control transactions are causing considerable controversy. Some argue that takeovers are damaging to the morale and productivity of organizations and therefore damaging to the economy. Others argue that takeovers represent productive entrepreneurial activity that improves the control and management of assets and helps move assets to more productive uses.

The controversy has been accompanied by strong pressure on regulators and legislatures to enact restrictions that would curb activity in the market for corporate control. In the spring of 1985 there were over 20 bills under consideration in Congress that proposed new restrictions on takeovers. Within the past several years the legislatures of New York, New Jersey, Maryland, Pennsylvania, Connecticut, Illinois, Kentucky, and Michigan have passed antitakeover laws. The Federal Reserve Board entered the fray early in 1986 when it issued its controversial new interpretation of margin rules that restricts the use of debt in takeovers.

Through dozens of studies, leading financial economists have accumulated considerable evidence and knowledge about the effects of the takeover market. Since most of the results of the work completed prior to 1984 are well summarized elsewhere,[4] I focus here on current aspects of the controversy and on new results. In a nutshell, the previous work tells us the following:

- Takeovers benefit target shareholders—premiums in hostile offers historically exceed 30 percent on average, and in recent times have averaged about 50 percent.
- Acquiring-firm shareholders on average earn about 4 percent in hostile takeovers and roughly zero in mergers.
- Takeovers do not waste credit or resources; they generate substantial gains—historically 8.4 percent of the total value of both companies. Recently the gains seem to have been even larger.
- Actions by managers that eliminate or prevent offers or mergers are most suspect as harmful to shareholders.
- Golden parachutes for top-level managers do not, on average, harm shareholders.
- The activities of takeover specialists such as Icahn,

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* This article is a somewhat shortened version of Michael C. Jensen's "The Takeover Controversy: Analysis and Evidence," which will appear in the forthcoming volume, *Takeovers and Contests for Corporate Control* (Oxford University Press, 1987), edited by John Coffee, Louis Lowenstein, and Susan Rose-Ackerman. It is printed here with permission of the publisher.

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[2] W. T. Grimm, *Mergerstat Review* (1985).

[4] A detailed summary of this evidence is available in Michael C. Jensen and Richard S. Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics* 11 (April, 1983); and in Michael C. Jensen, "Takeovers: Folklore and Science", *Harvard Business Review* (November/December, 1984). See also Paul J. Halpern, "Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers," *Journal of Business*, V. 46, No. 4 (October, 1973) pp. 554-575.

Posner, Steinberg, and Pickens, on average, benefit shareholders.[5]

- Takeover gains do not come from the creation of monopoly power.

This paper analyzes the controversy surrounding takeovers and provides both theory and evidence to explain the central phenomena at issue. The paper is organized as follows. Section 2 contains basic background analysis of the forces operating in the market for corporate control—analysis which provides an understanding of the conflicts and issues surrounding takeovers and the effects of activities in this market. Section 3 discusses the conflict between managers and shareholders over the payout of free cash flow and how takeovers represent both a symptom and a resolution of the conflict. Sections 4, 5, and 6 discuss the relatively new phenomena of, respectively, junk-bond financing, the use of golden parachutes, and the practice of greenmail. Section 7 analyzes the problems the Delaware court is having in dealing with the conflicts that arise over control issues and its confused application of the business judgment rule to these cases.

The following topics are discussed:

- The reasons for takeovers and mergers in the petroleum industry and why they increase efficiency and thereby promote the national interest.
- The role of debt in bonding management's promises to pay out future cash flows, to reduce costs, and to reduce investments in low-return projects.
- The role of high-yield debt (junk bonds) in helping to eliminate mere size as a takeover deterrent.
- The effects of takeovers on the equity markets and claims that managers are pressured to behave myopically.
- The effects of antitakeover measures such as poison pills.
- The misunderstandings of the important role that "golden parachutes" play in reducing the conflicts of interests associated with takeovers and the valuable function they serve in alleviating some of the costs and uncertainty facing managers.
- The damaging effects of the Delaware court decision in Unocal vs. Mesa that allowed Unocal to make a self-tender offer that excluded its largest shareholder (reverse greenmail).
- The problems the courts are facing in applying the model of the corporation subsumed under the traditional business judgment rule to the conflicts of interest involved in corporate control controversies.

The Market for Corporate Control—Background

The Benefits of Takeovers

The market for corporate control is creating large benefits for shareholders and for the economy as a whole. The corporate control market generates these gains by loosening control over vast amounts of resources and enabling them to move more quickly to their highest-valued use. This is a healthy market in operation, on both the takeover side and the divestiture side.

Gains to target firms. Total benefits created by the control market have been huge, as reflected in gains of $40 billion to stockholders of acquired firms in 260 tender offers alone in the period from January 1981 through May 1985.[6] This figure does not include the gains from other control transactions such as mergers, leveraged buyouts, or divestitures. Nor does it include the gains from reorganizations such as those of Phillips, Unocal and others that have been motivated by takeover attempts. (The Phillips, Unocal and ARCO reorganizations created gains of an additional $6.6 billion.) One study estimates the total premiums received by shareholders of target firms to have been approximately $75 billion in $239 billion of merger and acquisition deals in 1984 and 1985.[6a]

Gains to bidding firms. The evidence on the returns to bidding firms is mixed. The data indicate that prior to 1980 shareholders of bidding firms earned on average about zero in mergers (which tend to be voluntary) and about 4 percent of their equity value in tender offers (which tend to be hostile).[7] These differences in returns are associated with the form of payment rather than the form of the

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[5] Clifford G. Holderness and Dennis P. Sheehan, "Raiders or Saviors? The Evidence on Six Controversial Investors," *Journal of Financial Economics* 14 (December, 1985); and Wayne H. Mikkelson and Richard S. Ruback, "An Empirical Analysis of the Interfirm Equity Investment Process," *Journal of Financial Economics* 14 (December, 1985).

[6] As estimated by the Office of the Chief Economist of the SEC and provided to the author in private communication.

[6a] John D. Paulus, "Corporate Restructuring, 'Junk,' and Leverage: Too Much or Too Little?" (Morgan Stanley, February 1986).

[7] See Jensen and Ruback [1983, Tables 1 and 2], cited earlier in note 4.

Major changes in energy markets have required a radical restructuring of and retrenchment in that industry; and takeovers have played an important role in accomplishing these changes.

offer (tender offers tend to be for cash and mergers tend to be for stock).[8]

Although there are measurement problems that make it difficult to estimate the returns to bidders as precisely as the returns to targets,[12] it appears the bargaining power of target managers, coupled with competition among potential acquirers, grants much of the acquisition benefits to selling shareholders. In addition, federal and state regulation of tender offers appears to have strengthened the hand of target firms; premiums received by target-firm shareholders increased substantially after introduction of such regulation.[13]

Causes of Current Takeover Activity

The current high level of takeover activity seems to be caused by a number of factors:

- the relaxation of restrictions on mergers imposed by the antitrust laws;
- the withdrawal of resources from industries that are growing more slowly or that must shrink;
- deregulation in the financial services, oil and gas, transportation, and broadcasting markets that is bringing about a major restructuring of those industries;
- and improvements in takeover technology, including a larger supply of increasingly sophisticated legal and financial advisers, and improvements in financing technology (for example, the strip financing commonly used in leveraged buyouts and the original issuance of high-yield non-investment-grade bonds).

Each of these factors has contributed to the increase in total takeover and reorganization activity in recent times. Moreover, the first three factors (antitrust relaxation, exit, and deregulation) are generally consistent with data showing the intensity of takeover activity by industry. For example, the value of merger and acquisition transactions by industry in the period 1981-84 (see Table 1) indicates that acquisition activity was highest in oil and gas, followed by banking and finance, insurance, food processing, and mining and minerals. For comparison purposes, the last column of the table presents data on industry size measured as a fraction of the total value of all firms. All but two of the industries, retail and transportation, represent a larger fraction of total takeover activity than their representation in the economy as a whole.

Many areas of the U.S. economy have been experiencing slowing growth and, in some cases, even retrenchment—a phenomenon that has many causes, including substantially increased competition from foreign firms. This has increased takeover activity because takeovers play an important role in facilitating exit from an industry or activity. Major changes in energy markets have required a radical restructuring of and retrenchment in that industry; and, as discussed in detail below, takeovers have played an important role in accomplishing these changes. Deregulation of the financial service market is consistent with the high ranking in Table 1 of banking and finance and insurance. Deregulation has also been important in the transportation and broadcasting industries. Mining and minerals has been subject to many of the same forces affecting the energy industry, including the changes in the value of the dollar.

Takeovers Provide Competition for Top-level Management Jobs

The market for corporate control is best viewed as a major component of the managerial labor market. It is the arena in which different management teams compete for the rights to manage corporate resources.[14] Understanding this is crucial to understanding much of the rhetoric about the effects of hostile takeovers.

Managers formerly protected from competition for their jobs by antitrust constraints that prevented takeover of the nation's largest corporations are now facing a more demanding environment and a more uncertain future.

The development of innovative financing

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[8] See Yen-Sheng Huang and Ralph A. Walkling, "Differences in Residuals Associated with Acquisition Announcements: Payment, Acquisition Form, and Resistance Effects" (Manuscript, Georgia Institute of Technology and Ohio State University, November, 1985).

[12] See B. Espen Eckbo, "Do Acquiring Firms Gain From Merger?" (unpublished manuscript, University of British Columbia, June, 1985). Eckbo concludes that the zero returns to U.S. bidding firms is due to difficulties in measuring the gains to bidding firms when the bidder is substantially larger than the target firm. In his sample the average Canadian bidder was approximately the same size as the average target while the average U.S. bidder is approximately 8 times the size of the average Canadian target. See also Jensen and Ruback [1983, pp 18ff.], cited earlier in note 4.

[13] See Gregg Jarrell and Michael Bradley, "The Economic Effects of Federal and State Regulation of Cash Tender Offers," *Journal of Law and Economics* 23 (1980), pp. 371-407.

[14] See Jensen and Ruback [1983], cited earlier in note 4.

When the internal processes for change in large corporations are too slow, costly, and clumsy to bring about the required restructuring or management change, the capital markets are doing so through the operation of the market for corporate control.

TABLE 1
Intensity of Industry Takeover Activity: 1981–1984

Intensity of industry takeover activity as measured by the value of merger and acquisition transactions in the period 1981–84 (as a percent of total takeover transactions for which valuation data are publicly reported) compared to industry size (as measured by the fraction of overall corporate market value).

Industry classification of seller	Percent of total takeover activity*	Percent of total corporate market value**
Oil and gas	26.3%	13.5%
Banking and finance	8.8	6.4
Insurance	5.9	2.9
Food processing	4.6	4.4
Mining and minerals	4.4	1.5
Conglomerate	4.4	3.2
Retail	3.6	5.2
Transportation	2.4	2.7
Leisure and entertainment	2.3	.9
Broadcasting	2.3	.7
Other	39.4	58.5

*Source: W. T. Grimm, *Mergerstat Review* (1984), p. 41.
**As of 12/31/84. Total value is measured as the sum of the market value of common equity for 4,305 companies, including 1,501 companies on the NYSE, 724 companies on the ASE plus 2,080 companies in the Over-The-Counter market. Source: *The Media General Financial Weekly*, (December 31, 1984), p. 17.

vehicles, such as high-yield, non-investment-grade bonds ("junk" bonds), has removed size as a significant impediment to competition in this market. Although they have not been widely used in takeovers yet, these new financing techniques permit small firms to obtain resources for acquisition of much larger firms by issuing claims on the value of the venture (that is, the target firm's assets) just as in any other corporate investment activity. It is not surprising that many executives of large corporations would like relief from this new competition for their jobs, but restricting the corporate control market is not the efficient way to handle the problems caused by the increased uncertainty in their contracting environment.

Takeovers Provide External Control

The internal control mechanisms of corporations, which operate through the board of directors, generally work well. On occasion, however, they break down. One important source of protection for investors in these situations is the takeover market. Other management teams that recognize an opportunity to reorganize or redeploy an organization's assets and thereby create new value can bid for the control rights in the takeover market. To be successful, such bids must be at a premium over current market value. This gives investors an opportunity to realize part of the gains from reorganization and redeployment of the assets.

The Market for Corporate Control Is an Agent for Change

Takeovers generally occur because changing technology or market conditions require a major restructuring of corporate assets. In some cases takeovers occur because incumbent managers are incompetent. When the internal processes for change in large corporations are too slow, costly and clumsy to bring about the required restructuring or management change in an efficient way, the capital markets are doing so through the operation of the market for corporate control. In this sense, the capital markets have been responsible for bringing about substantial changes in corporate strategy in recent times.

Managers often have difficulty abandoning strategies they have spent years devising and im-

Some firms in the oil industry have to go out of business. This is cheaper to accomplish through merger and the orderly liquidation of marginal assets of the combined firms than by a slow, agonizing death in a competitive struggle in an industry with overcapacity.

plementing, even when those strategies no longer contribute to the organization's survival. Such changes often require abandonment of major projects, relocation of facilities, changes in managerial assignments, and closure or sale of facilities or divisions. It is easier for new top-level managers with no ties with current employees or communities to make such changes. Moreover, normal organizational resistance to change commonly lessens significantly early in the reign of new top-level managers. For example, the premium Carl Icahn was able to offer for TWA, and his victory over Texas Air in the battle for control of TWA, were made possible in part by the willingness of the TWA unions to negotiate favorable contract concessions with Icahn—concessions that TWA itself was unable to attain prior to the takeover conflict. Such organizational factors that make change easier for newcomers, coupled with a fresh view of the business, can be a major advantage to new managers after a takeover. On the other hand, lack of detailed knowledge about the firm also poses risks for new managers and increases the likelihood of mistakes.

Takeovers are particularly important in bringing about efficiencies when exit from an activity is required. The oil industry is a good example. Changing market conditions mandate a major restructuring of the petroleum industry, and none of this is the fault of management. Management, however, must adjust to the new energy environment and recognize that many old practices and strategies are no longer viable. It is particularly hard for many managers to deal with the fact that some firms in the oil industry have to go out of business. This is cheaper to accomplish through merger and the orderly liquidation of marginal assets of the combined firms than by a slow, agonizing death in a competitive struggle in an industry with overcapacity. The end of the latter process often comes in the bankruptcy courts, with high losses and unnecessary destruction of valuable parts of organizations that could be used productively by others.

In short, the external takeover market serves as a court of last resort that plays an important role in (1) creating organizational change, (2) motivating the efficient use of resources, and (3) protecting shareholders when the corporation's internal controls and board-level control mechanisms are slow, clumsy, or defunct.

Divestitures Are the Subject of Much Erroneous Criticism

If assets are to move to their most highly valued use, acquirers must be able to sell off assets to those who can use them more productively. Therefore, divestitures are a critical element in the functioning of the corporate control market, and it is thus important to avoid inhibiting them. Indeed, over 1200 divestitures occurred in 1985, a record level.[15] Labeling divestitures with emotional terms such as "bustups" is not a substitute for analysis or evidence.

Moreover, it is important to recognize that divested plants and assets do not disappear; they are reallocated. Sometimes they continue to be used in similar ways in the same industry, and in other cases they are used in very different ways and in different industries. But in all cases they are moving to uses that their new owners believe are more productive. This process is beneficial to society.

Finally, it is useful to recognize that the takeover and divestiture market provides a private market constraint against bigness for its own sake. The potential gains available to those who correctly perceive that a firm can be purchased for less than the value realizable from the sale of its components provide incentives for entrepreneurs to search out these opportunities and to capitalize on them by reorganizing such firms into smaller entities.

The mere possibility of such takeovers also motivates managers to avoid putting together uneconomic conglomerates and to break up existing ones. This is now happening. Recently it has appeared that many firms' defenses against takeovers have led to actions similar to those proposed by potential acquirers. Examples are the reorganizations occurring in the oil industry, the sale of "crown jewels," and divestitures brought on by the desire to liquidate large debts incurred to buy back stock or to make other payments to stockholders. Unfortunately, the basic economic sense of these transactions is often lost in a blur of emotional rhetoric and controversy.

The sale of a firm's crown jewels, for example, benefits shareholders when the price obtained for the division is greater than the present value of the future cash flows to the current owner. A takeover bid motivated by the desire to obtain such an underused division can stimulate current managers to re-

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[15] W. T. Grimm, *Mergerstat Review* (1985).

It is important to recognize that divested plants and assets do not disappear; they are reallocated...to uses that their new owners believe are more productive. This process is beneficial to society.

examine the economics of the firm's current structure and to sell one or more of its divisions to a third party who is willing to pay even more than the initial offerer. Brunswick's sale of its Sherwood Medical Division to American Home Products after a takeover bid by Whittaker (apparently motivated by a desire to acquire Sherwood) is an example of such a transaction. The total value to Brunswick shareholders of the price received for selling Sherwood to American Home Products plus the remaining value of Brunswick without Sherwood (the proceeds from the sale of Sherwood were distributed directly to Brunswick's shareholders) was greater than Whittaker's offer for the entire company.[16]

Managers May Behave Myopically But Markets Do Not

It has been been argued that growing institutional equity holdings and the fear of takeover cause managers to behave myopically and therefore to sacrifice long-term benefits to increase short-term profits. The arguments tend to confuse two separate issues: 1) whether *managers* are shortsighted and make decisions that undervalue future cash flows while overvaluing current cash flows (myopic managers); and 2) whether *security markets* are shortsighted and undervalue future cash flows while overvaluing near-term cash flows (myopic markets).

There is little formal evidence on the myopic managers issue, but I believe this phenomenon does occur. Sometimes it occurs when managers hold little stock in their companies and are compensated in ways that motivate them to take actions that increase accounting earnings rather than the value of the firm. It also occurs when managers make mistakes because they do not understand the forces that determine stock values.

There is much evidence inconsistent with the myopic markets view and none that supports it:

- Even casual observation of the equity markets reveals that the market values more than current earnings. It values growth as well. The mere fact that price/earnings ratios differ widely among securities indicates the market is valuing something other than current earnings. Indeed, the essence of a growth stock is one that has large investment projects yielding few short-term cash flows but high future earnings and cash flows.
- The continuing marketability of new issues for start-up companies with little record of current earnings—the Genentechs of the world—is also inconsistent with the notion that the market does not value future earnings.
- A recent study provides evidence that (except in the oil industry) stock prices respond positively to announcements of increased investment expenditures, and negatively to reduced expenditures.[17] This evidence is inconsistent with the notion that the equity market is myopic.
- The vast evidence on efficient markets indicating that current stock prices appropriately incorporate all currently available public information is also inconsistent with the myopic markets hypothesis. Although the evidence is not literally 100 percent in support of the efficient market hypothesis, there is no better documented proposition in any of the social sciences.[18]

The evidence indicates, for example, that the market appropriately interprets the implications of corporate accounting changes that increase reported profits but cause no change in corporate cash flows.[19]

Additional evidence is provided by the 30 percent increase in ARCO's stock price that occurred when it announced its major restructuring in 1985. This price increase is inconsistent with the notion that the market values only short-term earnings. Even though ARCO simultaneously revealed that it would have to take a $1.2 billion write-off as a result of the restructuring, the market still responded positively.

- Recent versions of the myopic markets hypothesis emphasize increasing institutional holdings and the pressures institutional investors face to show high returns on a quarter-to-quarter basis. It is argued that these pressures on institutions are a major cause of pressures on corporations to generate high current

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[16] See the analysis in Jensen [1984, p. 119], cited in note 4.

[17] John J. McConnell and Chris J. Muscarella, "Corporate Capital Expenditure Decisions and the Market Value of the Firm," *Journal of Financial Economics* 14, No. 3 (1985).

[18] For an introduction to the literature and empirical evidence on the theory of efficient markets, see E. Elton and M. Gruber, *Modern Portfolio Theory and Investment Analysis*, (New York: Wiley, 1984), Chapter 15, p. 375ff. and the 167 studies referenced in the bibliography.

[19] Examples are switches from accelerated to straight-line depreciation techniques and adoption of the flow-through method for reporting investment tax credits. Here the evidence indicates that "security prices increase around the date when a firm first announces earnings inflated by an accounting change. The effect appears to be temporary, and, certainly by the subsequent quarterly report, the price has resumed a level appropriate to the true economic status of the firm." See R. Kaplan and R. Roll, "Investor Evaluation of Accounting Information: Some Empirical Evidence," *Journal of Business*, (April, 1972), 225-257.

I believe this phenomenon [myopic managerial behavior] does occur. Sometimes it occurs when managers hold little stock in their companies and are compensated in ways that motivate them to take actions that increase accounting earnings rather than the value of the firm.

earnings on a quarter-to-quarter basis. The institutional pressures are said to lead to increased takeovers of firms (because institutions are not loyal shareholders) and to decreased research and development expenditures. It is argued that because R&D expenditures reduce current earnings, firms making them are therefore more likely to be taken over, and that reductions in R&D are leading to a fundamental weakening of the corporate sector of the economy.

A recent study of 324 firms by the Office of the Chief Economist of the SEC finds substantial evidence that is inconsistent with this version of the myopic markets argument.[20] The evidence indicates the following:

- increased institutional stock holdings are not associated with increased takeovers of firms;
- increased institutional holdings are not associated with decreases in research and development expenditures;
- firms with high research and development expenditures are not more vulnerable to takeovers;
- stock prices respond positively to announcements of increases in research and development expenditures.

Those who make the argument that takeovers are reducing R&D spending also have to come to grips with the aggregate data on such spending, which is inconsistent with the argument. Total spending on R&D in 1984, a year of record acquisition activity, increased by 14 percent according to *Business Week's* annual survey of 820 companies. (The sample companies account for 95 percent of total private-sector R&D expenditures.) This represented "the biggest gain since R&D spending began a steady climb in the late 1970s."[21] All industries in the survey increased R&D spending with the exception of steel. Moreover, R&D spending increased from 2 percent of sales, where it had been for five years, to 2.9 percent.

An Alternative Hypothesis

There is an alternative hypothesis that explains the current situation, including the criticisms of management, quite well.

Suppose that some managers are simply mistaken—that is, their strategies are wrong—and that the financial markets are telling them they are wrong. If they don't change, their stock prices will remain low. If the managers are indeed wrong, it is desirable for the stockholders and for the economy to remove them to make way for a change in strategy and more efficient use of the resources.

Free Cash Flow Theory of Takeovers[22]

More than a dozen separate forces drive takeover activity, including such factors as deregulation, synergies, economies of scale and scope, taxes, managerial incompetence, and increasing globalization of U.S. markets.[23] One major cause of takeover activity are the agency costs associated with conflicts between managers and shareholders over the payout of corporate free cash flow. Though this has received relatively little attention, it has played an important role in acquisitions over the last decade.

Managers are the agent of shareholders, and because both parties are self-interested, there are serious conflicts between them over the choice of the best corporate strategy. Agency costs are the total costs that arise in such cooperative arrangements. They consist of the costs of monitoring managerial behavior (such as the costs of producing audited financial statements and devising and implementing compensation plans that reward managers for actions that increase investors' wealth) and the inevitable costs that are incurred because the conflicts of interest can never be resolved perfectly. Sometimes these costs can be large and, when they are, takeovers can reduce them.

Free Cash Flow and the Conflict Between Managers and Shareholders

Free cash flow is cash flow in excess of that required to fund all projects that have positive net values when discounted at the relevant cost of capital. Such free cash flow must be paid out to share-

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[20] Office of the Chief Economist, Securities and Exchange Commission, "Institutional Ownership, Tender Offers, and Long-Term Investments," April 19, 1985.

[21] "R&D Scoreboard: Reagan & Foreign Rivalry Light a Fire Under Spending", *Business Week*, July 8, 1985), p. 86 ff.

[22] This discussion is based on my article, "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers," forthcoming in *American Economic Review*, (May, 1986).

[23] Richard Roll discusses a number of these forces in "Empirical Evidence on Takeover Activity and Shareholder Wealth," (presented at the Conference on Takeovers and Contests for Corporate Control, Columbia University, November, 1985).

> ***Free cash flow [that which cannot be profitably reinvested by management inside the firm] must be paid out to shareholders if the firm is to be efficient and to maximize value for shareholders.***

holders if the firm is to be efficient and to maximize value for shareholders.

Payment of cash to shareholders reduces the resources under managers' control, thereby reducing managers' power, and potentially subjecting them to the monitoring by the capital markets that occurs when a firm must obtain new capital. Financing projects internally avoids this monitoring and the possibility that funds will be unavailable or available only at high explicit prices.

Managers have incentives to expand their firms beyond the size that maximizes shareholder wealth.[24] Growth increases managers' power by increasing the resources under their control. In addition, changes in management compensation are positively related to growth.[25] The tendency of firms to reward middle managers through promotion rather than year-to-year bonuses also creates an organizational bias toward growth to supply the new positions that such promotion-based reward systems require.[25a]

The tendency for managers to overinvest resources is limited by competition in the product and factor markets, which tends to drive prices toward minimum average cost in an activity. Managers must therefore motivate their organizations to be more efficient to improve the probability of survival. Product and factor market disciplinary forces are often weaker in new activities, however, and in activities that involve substantial economic rents or quasi-rents.[26] In these cases, monitoring by the firm's internal control system and the market for corporate control are more important. Activities yielding substantial economic rents or quasi-rents are the types of activities that generate large amounts of free cash flow.

Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than invest it at below the cost of capital or waste it through organizational inefficiencies.

Some finance scholars have argued that financial flexibility (unused debt capacity and internally generated funds) is desirable when a firm's managers have better information about the firm than outside investors.[26a] Their arguments assume that managers act in the best interest of shareholders. The arguments offered here imply that such flexibility has costs: financial flexibility in the form of free cash flow, large cash balances, and unused borrowing power provides managers with greater discretion over resources that is often not used in the shareholders' interests.

The theory developed here explains (1) how debt-for-stock exchanges reduce the organizational inefficiencies fostered by substantial free cash flow, (2) how debt can substitute for dividends, (3) why "diversification" programs are more likely to be associated with losses than are expansion programs in the same line of business, (4) why mergers within an industry and liquidation-motivated takeovers will generally create larger gains than cross-industry mergers, (5) why the factors stimulating takeovers in such diverse businesses as broadcasting, tobacco, cable systems and oil are essentially identical, and (5) why bidders and some targets tend to show abnormally good performance prior to takeover.

The Role of Debt in Motivating Organizational Efficiency

The agency costs of debt have been widely discussed,[27] but the benefits of debt in motivating managers and their organizations to be efficient have largely been ignored. I call these effects the "control hypothesis" for debt creation.

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[24] See Gordon Donaldson, *Managing Corporate Wealth*, (Praeger: 1984). Donaldson, in a detailed study of 12 large Fortune 500 firms, concludes that managers of these firms were not driven by maximization of the value of the firm, but rather by the maximization of "corporate wealth." He defines corporate wealth as "*the aggregate purchasing power available to management for strategic purposes during any given planning period.* ... this wealth consists of the stocks and flows of cash and cash equivalents (primarily credit) that management can use at its discretion to implement decisions involving the control of goods and services." (p. 3, emphasis in original) "In practical terms it is cash, credit, and other corporate purchasing power by which management commands goods and services." (p.22).

[25] Where growth is measured by increases in sales. See Kevin J. Murphy, "Corporate Performance and Managerial Remuneration: An Empirical Analysis," *Journal of Accounting and Economics* 7, Nos. 1-3 (April, 1985), pp. 11-42. This positive relationship between compensation and sales growth does not imply, although it is consistent with, causality.

[25a] See George Baker, "Compensation and Hierarchies" (unpublished, Harvard Business School, January, 1986).

[26] Rents are returns in excess of the opportunity cost of the resources committed to the activity. Quasi-rents are returns in excess of the short-run opportunity cost of the resources to the activity.

[26a] See Stewart C. Myers and Nicholas S. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have," *Journal of Financial Economics* 13 (1984), pp. 187-221.

[27] See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, V. 3 (1976), pp. 305-360; Stewart C. Myers, "Determinants of Corporate Borrowing," *Journal of Financial Economics*, V. 5, No. 2 (1977), pp. 147-175; and Clifford W. Smith, Jr. and Jerold B. Warner, "On Financial Contracting: An Analysis of Bond Covenants," *Journal of Financial Economics*, V. 7 (1979), pp. 117-161.

The control function of debt is more important in organizations that generate large cash flows but have low growth prospects, and it is even more important in organizations that must shrink.

Managers with substantial free cash flow can increase dividends or repurchase stock and thereby pay out current cash that would otherwise be invested in low-return projects or otherwise wasted. This payout leaves managers with control over the use of future free cash flows, but they can also promise to pay out future cash flows by announcing a "permanent" increase in the dividend.[28] Because there is no contractual obligation to make the promised dividend payments, such promises are weak. Dividends can be reduced by managers in the future with little effective recourse to shareholders. The fact that capital markets punish dividend cuts with large stock price reductions is an interesting equilibrium market response to the agency costs of free cash flow.[29]

Debt creation, without retention of the proceeds of the issue, enables managers effectively to bond their promise to pay out future cash flows. Thus, debt can be an effective substitute for dividends, something that is not generally recognized in the corporate finance literature.[30] By issuing debt in exchange for stock, managers bond their promise to pay out future cash flows in a way that simple dividend increases do not. In doing so, they give shareholder-recipients of the debt the right to take the firm into bankruptcy court if they do not keep their promise to make the interest and principal payments.[31] Thus, debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers.

Issuing large amounts of debt to buy back stock sets up organizational incentives to motivate managers to pay out free cash flow. In addition, the exchange of debt for stock also helps managers overcome the normal organizational resistance to retrenchment that the payout of free cash flow often requires. The threat of failure to make debt-service payments serves as a strong motivating force to make such organizations more efficient. Stock repurchase for debt or cash also has tax advantages. Interest payments are tax-deductible to the corporation; the part of the repurchase proceeds equal to the seller's tax basis in the stock is not taxed at all, and that which is taxed is subject to capital-gains rates.

The control hypothesis does not imply that debt issues will always have positive control effects. For example, these effects will not be as important for rapidly growing organizations with large and highly profitable investment projects but no free cash flow. Such organizations will have to go regularly to the financial markets to obtain capital. At these times the markets will have an opportunity to evaluate the company, its management, and its proposed projects. Investment bankers and analysts play an important role in this monitoring, and the market's assessment is made evident by the price investors pay for the financial claims.

The control function of debt is more important in organizations that generate large cash flows but have low growth prospects, and it is even more important in organizations that must shrink. In these organizations the pressures to waste cash flows by investing them in uneconomic projects are most serious.

[The original paper contains a section here entitled "Evidence from Financial Transactions in Support of the Free Cash Flow Theory of Mergers," which appears in the "Appendix" to this article.]

The Evidence from Leveraged Buyout and Going-Private Transactions

Many of the benefits of going-private and leveraged buyout transactions seem to be due to the control function of debt. These transactions are creating a new organizational form that competes

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[28] Interestingly, Graham and Dodd, in their treatise, *Security Analysis*, placed great importance on the dividend payout in their famous valuation formula: V = M (D + .33E)(p.454). V is value, M is the earnings multiplier when the dividend payout rate is a "normal two-thirds of earnings," D is the expected dividend, and E is expected earnings. In their formula, dividends are valued at three times the rate of retained earnings, a proposition that has puzzled many students of modern finance (at least of my vintage). The agency cost of free cash flow that leads to overretention and waste of shareholder resources is consistent with the deep suspicion with which Graham and Dodd viewed the lack of payout. Their discussion (chapter 34) reflects a belief in the tenuous nature of the future benefits of such retention. Although they do not couch the issues in terms of the conflict between managers and shareholders, the free cash flow theory explicated here implies that their beliefs, sometimes characterized as "a bird in the hand is worth two in the bush," were perhaps well founded. See Chapters 32, 34, and 36 in Benjamin Graham and David L. Dodd, *Security Analysis: Principles and Technique* (New York, McGraw-Hill, 1951).

[29] See Guy Charest, "Dividend Information, Stock Returns, and Market Efficiency-II, *Journal of Financial Economics* 6, (1978), pp. 297-330; and Joseph Aharony and Itzhak Swary, "Quarterly Dividend and Earnings Announcements and Stockholder's Returns: An Empirical Analysis," *Journal of Finance* 35 (1980), pp. 1-12.

[30] Literally, principal and interest payments are substitutes for dividends. However, because interest is tax-deductible at the corporate level and dividends are not, dividends and debt are not perfect substitutes.

[31] Two studies argue that regular dividend payments can be effective in reducing agency costs with managers by assuring that managers are forced more frequently to subject themselves and their policies to the discipline of the capital markets when they acquire capital. See Frank H. Easterbrook, "Managers' Discretion and Investors' Welfare: Theories and Evidence," *Delaware Journal of Corporate Law*, V. 9, No. 3 (1984b), pp. 540-571; and Michael Rozeff, "Growth, Beta and Agency Costs as Determinants of Dividend Payout Ratios" *Journal of Financial Research*, V 5 (1982), pp. 249-99.

If managers [of companies with strip financing] withhold dividends to invest in value-reducing projects or if they are simply incompetent, strip holders have recourse to remedial powers not available to the equity holders [in firms without strip financing].

successfully with the open corporate form because of advantages in controlling the agency costs of free cash flow. In 1984, going-private transactions totaled $10.8 billion and represented 27 percent of all public acquisitions.[36] The evidence indicates premiums paid averaged over 50 percent.[37]

Desirable leveraged buyout candidates are frequently firms or divisions of larger firms that have stable business histories and substantial free cash flow (that is, low growth prospects and high potential for generating cash flows)—situations where agency costs of free cash flow are likely to be high. Leveraged buyout transactions are frequently financed with high debt; ten-to-one ratios of debt to equity are not uncommon. Moreover, the use of strip financing and the allocation of equity in the deals reveal a sensitivity to incentives, conflicts of interest, and bankruptcy costs.

Strip financing, the practice in which risky nonequity securities are held in approximately equal proportions, limits the conflict of interest among such security holders and therefore limits bankruptcy costs. A somewhat oversimplified example illustrates the point. Consider two firms identical in every respect except financing. Firm A is entirely financed with equity, and Firm B is highly leveraged with senior subordinated debt, convertible debt, and preferred as well as equity. Suppose Firm B securities are sold only in strips—that is, a buyer purchasing X percent of any security must purchase X percent of all securities, and the securities are "stapled" together so they cannot be separated later. Security holders of both firms have identical unlevered claims on the cash flow distribution, but organizationally the two firms are very different. If Firm B managers withhold dividends to invest in value-reducing projects or if they are simply incompetent, strip holders have recourse to remedial powers not available to the equity holders of Firm A. Each Firm B security specifies the rights its holder has in the event of default on its dividend or coupon payment—for example, the right to take the firm into bankruptcy or to have board representation. As each security above equity goes into default the strip holder receives new rights to intercede in the organization. As a result, it is quicker and less expensive to replace managers in Firm B.

Moreover, because every security holder in the highly levered Firm B has the same claim on the firm, there are no conflicts between senior and junior claimants over reorganization of the claims in the event of default; to the strip holder it is a matter of moving funds from one pocket to another. Thus, Firm B need never go into bankruptcy. The reorganization can be accomplished voluntarily, quickly, and with less expense and disruption than through bankruptcy proceedings.

Securities commonly subject to strip practices are often called "mezzanine" financing and include securities with priority superior to common stock yet subordinate to senior debt. This seems to be a sensible arrangement. Because of several other factors ignored in our simplified example, IRS restrictions deny tax deductibility of debt interest in such situations and bank holdings of equity are restricted by regulation. Riskless senior debt need not be in the strip because there are no conflicts with other claimants in the event of reorganization when there is no probability of default on its payments.

It is advantageous to have top-level managers and venture capitalists who promote the transactions hold a larger share of the equity. Top-level managers frequently receive 15 to 20 percent of the equity, and venture capitalists and the funds they represent generally retain the major share of the remainder. The venture capitalists control the board of directors and monitor managers. Managers and venture capitalists have a strong interest in making the venture successful because their equity interests are subordinate to other claims. Success requires, among other things, implementation of changes to avoid investment in low-return projects in order to generate the cash for debt service and to increase the value of equity. Finally, when the equity is held primarily by managers or generally by a small number of people, greater efficiencies in risk bearing are made possible by placing more of the risk in the hands of debt holders when the debt is held in well-diversified institutional portfolios.

Less than a handful of these leveraged buyout ventures have ended in bankruptcy, although more have gone through private reorganizations. A thorough test of this organizational form requires the passage of time and another recession.

Some have asserted that managers engaging in a

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[36] By number. See W. T. Grimm, Mergerstat Review (1985), Figs. 36 and 37.

[37] See H. DeAngelo, L. DeAngelo and E. Rice, "Going Private: Minority Freezeouts and Stockholder Wealth," *Journal of Law and Economics*, V. 27, No. 2 (October, 1984), pp. 367-401; and Louis Lowenstein, "Management Buyouts," *Columbia Law Review*, V. 85 (May, 1985), pp. 730-784. Lowenstein also mentions incentive effects of debt but argues tax effects play a major role in explaining the value increase.

Because the venture capitalists are generally the largest shareholder and control the board of directors, they have both greater ability and stronger incentives to monitor managers than directors representing diffuse public shareholders in the typical public corporation.

buyout of their firm are insulating themselves from monitoring. The opposite is true in the typical leveraged buyout. Because the venture capitalists are generally the largest shareholder and control the board of directors, they have both greater ability and incentives to monitor managers effectively than directors representing diffuse public shareholders in the typical public corporation.

Evidence from the Oil Industry

The oil industry is large and visible. It is also an industry in which the importance of takeovers in motivating change and efficiency is particularly clear. Therefore, detailed analysis of it provides an understanding of how the market for corporate control helps motivate more efficient use of resources in the corporate sector.

Reorganization of the industry is mandatory. Radical changes in the energy market from 1973 through the late 1970s imply that a major restructuring of the petroleum industry had to occur. These changes are as follows:

- a ten-fold increase in the price of crude oil from 1973 to 1979;
- reduced annual consumption of oil in the U.S.;
- reduced expectations of future increases in the price of oil;
- increased exploration and development costs;
- and increased real interest rates.

As a result of these changes the optimal level of refining and distribution capacity and crude reserves fell over this period, and since the late 1970s the industry has been plagued with excess capacity. Reserves are reduced by reducing the level of exploration and development, and it pays to concentrate these reductions in high-cost areas such as the United States.

Substantial reductions in exploration and development and in refining and distribution capacity meant that some firms had to leave the industry. This is especially true because holding reserves is subject to economies of scale, whereas exploration and development are subject to diseconomies of scale.

Price increases created large cash flows in the industry. For example, 1984 cash flows of the ten largest oil companies were $48.5 billion, 28 percent of the total cash flows of the top 200 firms in Dun's Business Month [1985] survey. Consistent with the agency costs of free cash flow, management did not pay out the excess resources to shareholders. Instead, the industry continued to spend heavily on exploration and development even though average returns on these expenditures were below the cost of capital.

Paradoxically, the profitability of oil exploration and drilling activity can decrease even though the price of oil increases if the value of reserves in the ground falls. This can happen when the price increase is associated with reductions in consumption that make it difficult to market newly discovered oil. In the late 1970s the increased holding costs associated with higher real interest rates, reductions in expected future oil price increases, increased exploration and development costs, and reductions in the consumption of oil combined to make many exploration and development projects uneconomic. The industry, however, continued to spend heavily on such projects.

The hypothesis that oil-industry exploration and development expenditures were too high during this period is consistent with the findings of the earlier-mentioned study by McConnell and Muscarella.[38] Their evidence indicates that announcements of increases in exploration and development expenditures by oil companies in the period 1975-1981 were associated with systematic decreases in the announcing firms' stock prices. Moreover, announcements of decreases in exploration and development expenditures were associated with increases in stock prices. These results are striking in comparison with their evidence that exactly the opposite market reaction occurs with increases and decreases in investment expenditures by industrial firms, and with SEC evidence that increases in research and development expenditures are associated with increased stock prices.[38a]

Additional evidence of the uneconomic nature of the oil industry's exploration and development expenditures is contained in a study by Bernard

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[38] John J. McConnell and Chris J. Muscarella, "Corporate Capital Expenditure Decisions and the Market Value of the Firm," *Journal of Financial Economics*, V. 14, No. 3 (1985).

[38a] Office of the Chief Economist, Securities and Exchange Commission, "Institutional Ownership, Tender Offers, and Long-Term Investments," April 19, 1985.

Wall Street was not undervaluing the oil; it was valuing it correctly, but it was also correctly valuing the wasted expenditures on exploration and development that oil companies were making.

Picchi of Salomon Brothers. His study of rates of return on exploration and development expenditures for 30 large oil firms indicated that on average the industry did not earn "even a 10% return on its pretax outlays" in the period 1982-84. Estimates of the average ratio of the present value of future net cash flows of discoveries, extensions and enhanced recovery to expenditures for exploration and development for the industry ranged from less than .6 to slightly more than .9, depending on the method used and the year. In other words, even taking the cost of capital to be only 10 percent on a pretax basis, the industry was realizing on average only 60 to 90 cents on every dollar invested in these activities. Picchi concludes:

> *For 23 of the [30] companies in our survey, we would recommend* immediate *cuts of perhaps 25%-30% in exploration and production spending. It is clear that much of the money that these firms spent last year on petroleum exploration and development yielded subpar financial returns—even at $30 per barrel, let alone today's $26-$27 per barrel price structure."*[39]

The waste associated with excessive exploration and development expenditures explains why buying oil on Wall Street was considerably cheaper than obtaining it by drilling holes in the ground, even after adjustment for differential taxes and regulations on prices of old oil. Wall Street was not undervaluing the oil; it was valuing it correctly, but it was also correctly valuing the wasted expenditures on exploration and development that oil companies were making. When these managerially imposed "taxes" on the reserves were taken into account, the net price of oil on Wall Street was very low. This provided incentives for firms to obtain reserves by purchasing other oil companies and reducing expenditures on non-cost-effective exploration.

High profits are not usually associated with retrenchment. Adjustment by the energy industry to the new environment has been slow for several reasons. First, it is difficult for organizations to change operating rules and practices like those in the oil industry that have worked well for long periods in the past, even though they do not fit the new situation. Nevertheless, survival requires that organizations adapt to major changes in their environment.

Second, the past decade has been a particularly puzzling period in the oil business because at the same time that changes in the environment have required a reduction of capacity, cash flows and profits have been high. This is a somewhat unusual condition in which the average productivity of resources in the industry increased while the marginal productivity decreased. The point is illustrated graphically in Figure 1.

As the figure illustrates, profits plus payments to factors of production other than capital were larger in 1985 than in 1973. Moreover, because of the upward shift and simultaneous twist of the marginal productivity of capital schedule from 1973 to 1985, the optimal level of capital devoted to the industry fell from Q_1 to Q_2. Thus, the adjustment signals were confused because the period of necessary retrenchment coincided with substantial increases in value brought about by the tenfold increase in the price of the industry's major asset, its inventory of crude oil reserves.

The large cash flows and profits generated by the increases in oil prices both masked the losses imposed on marginal facilities and enabled oil companies to finance major expenditures internally. Thus, the normal disciplinary forces of the product market have been weak, and those of the capital markets have been inoperative, during the past decade.

Third, the oil companies' large and highly visible profits subjected them to strong political pressures to reinvest the cash flows in exploration and development to respond to the incorrect, but popular, perception that reserves were too low. Furthermore, while reserves were on average too high, those firms which were substantially short of reserves were spending to replenish them to avoid the organizational consequences associated with reserve deficiencies. The resulting excessive exploration and development expenditures by the industry and the considerable delays in retrenchment of refining and distribution facilities wasted resources.

In sum, the stage was set for retrenchment in the oil industry in the early 1980s. Yet the product and capital markets could not force management to change its strategy because the industry's high internal cash flows insulated it from these pressures.

The fact that oil industry managers tried to invest funds outside the industry is also evidence that they could not find enough profitable projects within the industry to use the huge inflow of resources

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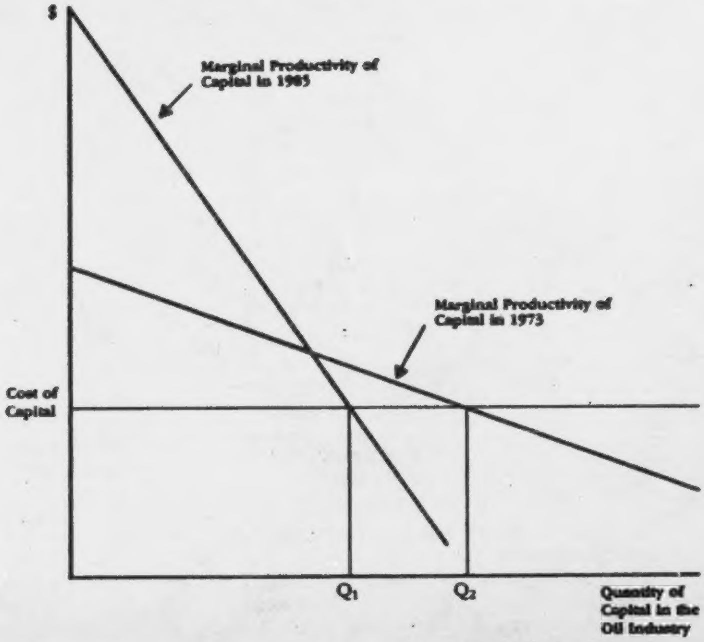
[39] Bernard J. Picchi, "The Structure of the U.S. Oil Industry: Past and Future" (Salomon Brothers Inc.) July, 1985, emphasis in original.

Partly as a result of Mesa's efforts, firms in the [oil] industry were led to merge, and in the merging process they paid out large amounts of capital to shareholders, reduced excess expenditures on exploration and development, and reduced excess capacity in refining and distribution.

FIGURE 1
Marginal Productivity of Capital in the Oil Industry:
1985 vs. 1973



efficiently. Unfortunately these efforts failed. The diversification programs involved purchases of companies in retailing (Marcor by Mobil), manufacturing (Reliance Electric by Exxon), office equipment (Vydec by Exxon), and mining (Kennecott by Sohio, Anaconda Minerals by ARCO, Cyprus Mines by Amoco). These acquisitions turned out to be among the least successful of the last decade, partly because of bad luck (e.g., the collapse of the minerals industry) and partly because of a lack of managerial expertise outside the oil industry.

The effects of takeovers. Ultimately the capital markets, through the takeover market, have begun to force managers to respond to the new market conditions. Unfortunately, there is widespread confusion about the important role of takeovers in bringing about the difficult but necessary organizational changes required in the retrenchment.

Managers, quite naturally, want large amounts of resources under their control to insulate them from the uncertainties of markets.[40] Retrenchment requires cancellation or delay of many ongoing and planned projects. This affects the careers of the people involved, and the resulting resistance means that such changes frequently do not get made without the major pressures associated with a crisis. A takeover attempt can create the crisis that brings about action where none would otherwise occur.

T. Boone Pickens of Mesa Petroleum perceived early that the oil industry must be restructured. Partly as a result of Mesa's efforts, firms in the industry were led to merge, and in the merging process they

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[40] See Gordon Donaldson, *Managing Corporate Wealth* (Praeger: 1984).

Horizontal mergers for cash or debt in declining industries generate gains by encouraging exit of resources (through payout to shareholders) and by substituting existing capacity for investment in new facilities by firms that are short of capacity.

paid out large amounts of capital to shareholders, reduced excess expenditures on exploration and development, and reduced excess capacity in refining and distribution.

The result has been large gains in efficiency. Total gains to the shareholders in the Gulf-Chevron, Getty-Texaco and Dupont-Conoco mergers, for example, were over $17 billion. Much more is possible. A study by Allen Jacobs estimates that, as of December 1984, the total potential gains from eliminating the inefficiencies in 98 petroleum companies amounted to roughly $200 billion.[41]

Recent events indicate that actual takeover is not necessary to bring about the required adjustments:

- The Phillips restructuring plan, in response to the threat of takeover, has involved substantial retrenchment and return of resources to shareholders; and the result was a $1.2 billion (20%) gain in Phillips' market value. It repurchased 53 percent of its stock for $4.5 billion in debt, raised its dividend 25 percent, cut capital spending and initiated a program to sell $2 billion of assets.
- Unocal's defense in the Mesa tender offer battle resulted in a $2.2 billion (35%) gain to shareholders from retrenchment and return of resources to shareholders. It paid out 52 percent of its equity by repurchasing stock with a $4.2 billion debt issue and will reduce costs and capital expenditures.
- The voluntary restructuring announced by ARCO resulted in a $3.2 billion (30%) gain in market value. ARCO's restructuring involves a 35 to 40 percent cut in exploration and development expenditures, repurchase of 25 percent of its stock for $4 billion, a 33 percent increase in its dividend, withdrawal from gasoline marketing and refining east of the Mississippi, and a 13 percent reduction in its work force.
- The announcement of the Diamond-Shamrock reorganization in July 1985 provides an interesting contrast to the others and further support for the theory because the company's market value *fell* 2 percent on the announcement day. Because the plan results in an effective increase in exploration and capital expenditures and a reduction in cash payouts to investors, the restructuring does not increase the value of the firm. The plan involved reducing cash dividends by $.76/share (−43%), creating a master limited partnership to hold properties accounting for 35 percent of its North American oil and gas production, paying an annual $.90/share dividend in partnership shares, repurchasing 6 percent of its shares for $200 million, selling 12 percent of its master limited partnership to the public, and *increasing* its expenditures on oil and gas exploration by $100 million per year.

Free Cash Flow Theory of Takeovers

Free cash flow is only one of approximately a dozen theories to explain takeovers, all of which are of some relevance in explaining the numerous forces motivating merger and acquisition activity.[41a] The agency cost of free cash flow is consistent with a wide range of data for which there has been no consistent explanation. Here I sketch some empirical predictions of the free cash flow theory for takeovers and mergers, and what I believe are the facts that lend it credence.

The positive market response to debt creation in oil and other takeovers is consistent with the agency costs of free cash flow and the control hypothesis of debt.[41b] The data is consistent with the notion that additional debt has increased efficiency by forcing organizations with large cash flows but few high-return investment projects to pay out cash to investors. The debt helps prevent such firms from wasting resources on low-return projects.

Acquisitions are one way managers spend cash instead of paying it out to shareholders. Therefore, free cash flow theory predicts which kinds of mergers and takeovers are more likely to destroy rather than to create value. It shows how takeovers are both evidence of the conflicts of interest between the shareholders and managers and a response to the problem. The theory implies that managers of firms with unused borrowing power and large free cash flows are more likely to undertake low-benefit or even value-destroying mergers. Diversification programs generally fit this category, and the theory predicts they will generate lower total gains. The major benefit of such diversifying transactions may be that they involve less waste of resources than if the funds had been invested

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[41] Allen Jacobs, "The Agency Cost of Corporate Control: The Petroleum Industry," (MIT, unpublished paper, March, 1986).

[41a] See Roll, 1986, cited earlier.

[41b] See Robert Bruner, "The Use of Excess Cash and Debt Capacity as a Motive for Merger," (unpublished, Colgate Darden Graduate School of Business, December, 1985).

Firms with a mismatch between growth and resources—firms with high growth, low liquidity, and high leverage, and firms with low growth, high liquidity, and lower leverage—are more likely to be taken over.

internally in unprofitable projects.[41c]

Low-return mergers are more likely to occur in industries with large cash flows where the economics dictate retrenchment. Horizontal mergers (where cash or debt is the form of payment) within declining industries will tend to create value because they facilitate exit; the cash or debt payments to shareholders of the target firm cause resources to leave the industry directly. Mergers outside the industry are more likely to have low or even negative returns because managers are likely to know less about managing such firms.

Oil fits this description and so does tobacco. Tobacco firms face declining demand as a result of changing smoking habits, but they generate large free cash flow and have been involved in major diversifying acquisitions recently—for example, the $5.6 billion purchase of General Foods by Philip Morris. The theory predicts that these acquisitions in non-related industries are more likely to create negative productivity effects—though these negative effects appear to be outweighed by the reductions in waste from internal expansion.

Forest products is another industry with excess capacity and acquisition activity, including the acquisition of St. Regis by Champion International and Crown Zellerbach by Sir James Goldsmith. Horizontal mergers for cash or debt in such an industry generate gains by encouraging exit of resources (through payout) and by substituting existing capacity for investment in new facilities by firms that are short of capacity.

Food-industry mergers also appear to reflect the expenditure of free cash flow. The industry apparently generates large cash flows with few growth opportunities. It is therefore a good candidate for leveraged buyouts, and these are now occurring; the $6.3 billion Beatrice LBO is the largest ever.

The broadcasting industry generates rents in the form of large cash flows on its licenses and also fits the theory. Regulation limits the overall supply of licenses and the number owned by a single entity. Thus profitable internal investments are limited and the industry's free cash flow has been spent on organizational inefficiencies and diversification programs, making these firms takeover targets. The CBS debt-for-stock exchange and restructuring as a defense against the hostile bid by Turner fits the theory, as does the $3.5 billion purchase of American Broadcasting Company by Capital Cities Communications. Completed cable systems also create agency problems from free cash flows in the form of rents on their franchises and quasi-rents on their investment, and are thus likely targets for acquisition and leveraged buyouts.

Large cash flows earned by motion picture companies on their film libraries also represent quasi-rents and are likely to generate free cash flow problems. Similarly, the attempted takeover of Disney and its subsequent reorganization is consistent with the theory. Drug companies with large cash flows from previous successful discoveries and few potential future prospects are also likely candidates for large agency costs of free cash flow.

The theory predicts that value-increasing takeovers occur in response to breakdowns of internal control processes in firms with substantial free cash flow and organizational policies (including diversification programs) that are wasting resources. It predicts hostile takeovers, large increases in leverage, the dismantling of empires with few economies of scale or scope to give them economic purpose (e.g. conglomerates), and much controversy as current managers object to loss of their jobs or changes in organizational policies forced on them by threat of takeover.

The debt created in a hostile takeover (or takeover defense) of a firm suffering severe agency costs of free cash flow need not be permanent. Indeed, sometimes it is desirable to "over-leverage" such a firm. In these situations, levering the firm so highly it cannot continue to exist in its old form yields

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[41c] Acquisitions made with cash or securities other than stock involve payout of resources to (target) shareholders, and this can create net benefits even if the merger creates operating inefficiencies. To illustrate the point, consider an acquiring firm, A, with substantial free cash flow that the market expects will be invested in low-return projects with a negative net present value of $100 million. If Firm A makes an acquisition of Firm B that generates zero synergies but uses up all of Firm A's free cash flow (and thereby prevents its waste) the combined market value of the two firms will *rise* by $100 million. The market value increases because the acquisition eliminates the expenditures on internal investments with negative market value of $100 million. Extending the argument, we see that acquisitions that have negative synergies of up to $100 million in current value will still increase the combined market value of the two firms. Such negative-synergy mergers will also increase social welfare and aggregate productivity whenever the market value of the negative productivity effects on the two merging firms is less than the market value of the waste that would have occurred with the firms' investment programs in the absence of the merger. The division of the gains between the target and bidding firms depends, of course, on the bargaining power of the two parties. Because the bidding firms are using funds that would otherwise have been spent on low- or negative-return projects, however, the opportunity cost of the funds is lower than their cost of capital. As a result, they will tend to overpay for the acquisition and thereby transfer most, if not all, of the gains to the target firm's shareholders. In extreme cases they may pay so much that the bidding-firm share price falls, in effect giving the target-shareholders more than 100 percent of the gains. These predictions are consistent with the evidence.

The abolition of mere size as a deterrent to takeover...has made possible the realization of large gains from reallocating larger collections of assets to more productive uses.

benefits. It creates the crisis to motivate cuts in expansion programs and the sale of those divisions that are more valuable outside the firm. The proceeds are used to reduce debt to a more normal or permanent level. This process results in a complete rethinking of the organization's strategy and structure. When it is successful, a much leaner, more efficient, and competitive organization results.

Some Evidence from Merger Studies

Consistent with the data, free cash flow theory predicts that many acquirers will tend to perform exceptionally well prior to acquisition. That exceptional stock price performance will often be associated with increased free cash flow which is then used for acquisition programs. The oil industry fits this description. Increased oil prices caused large gains in profits and stock prices in the mid-to-late 1970s. Empirical evidence from studies of both stock prices and accounting data also indicates exceptionally good performance for acquirers prior to acquisition.[42]

Targets will tend to be of two kinds: firms with poor management that have done poorly before the merger, and firms that have done exceptionally well and have large free cash flow that they refuse to pay out to shareholders....In the best study to date of the determinants of takeover, Palepu [1986] finds strong evidence consistent with the free cash flow theory of mergers. He studied a sample of 163 firms that were acquired in the period 1971-1979 and a random sample of 256 firms that were not acquired. Both samples were in mining and manufacturing and were listed on either the New York or American Stock Exchange. He finds that target firms were characterized by significantly lower growth and lower leverage than the nontarget firms, although there was no significant difference in their holdings of liquid assets. He also finds that poor prior performance (measured by the net-of-market returns in the four years before the acquisition) is significantly related to the probability of takeover, and, interestingly, that accounting measures of past performance such as return on equity are unrelated to the probability of takeover. He also finds that firms with a mismatch between growth and resources are more likely to be taken over. These are firms with high growth (measured by average sales growth), low liquidity (measured by the ratio of liquid assets to total assets) and high leverage, and firms with low growth, high liquidity, and low leverage. Finally, Palepu's evidence rejects the hypothesis that takeovers are due to the undervaluation of a firm's assets as measured by the market-to-book ratio.[42a]

High-Yield ("Junk") Bonds

The last several years have witnessed a major innovation in the financial markets with the establishment of active markets in high-yield bonds. These bonds are rated below investment grade by the bond rating agencies and are frequently referred to as junk bonds, a disparaging term that bears no relation to their pedigree. They carry interest rates that are 3 to 5 percentage points higher than the yields on government bonds of comparable maturity. High-yield bonds are best thought of as commercial loans that can be resold in secondary markets. By traditional standards they are more risky than investment-grade bonds and therefore carry higher interest rates. An early study finds the default rates on these bonds have been low and the realized returns have been disproportionately higher than their risk.[43a]

High-yield bonds have been attacked by those who wish to inhibit their use, particularly in the financing of takeover bids. The invention of high-yield bonds has provided methods to finance takeover ventures like those companies use to finance more traditional ventures. Companies commonly raise funds to finance ventures by selling claims to be paid from the proceeds of the venture; this is the essence of debt or stock issues used to finance new ventures. High-yield bonds used in takeovers work similarly. The bonds provide a claim on the proceeds of the venture, using the assets and cash flows of the target

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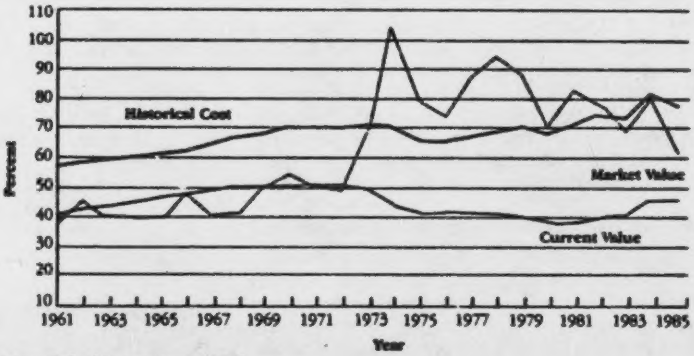
[42] See the following two papers which were presented at the Conference on Takeovers and Contests for Corporate Control, Columbia University, November, 1985: Ellen B. Magenheim and Dennis Mueller, "On Measuring the Effect of Acquisitions on Acquiring Firm Shareholders, or Are Acquiring Firm Shareholders Better Off After an Acquisition Than They Were Before?"; and Michael Bradley and Gregg Jarrell, "Evidence on Gains from Mergers and Takeovers." See also Paul R. Asquith and E. Han Kim, "The Impact of Merger Bids on the Participating Firms' Security Holders," *Journal of Finance*, 37, 1209-1228; Gershon Mandelker, "Risk and Return: The Case of Merging Firms," *Journal of Financial Economics*, V. 1, No. 4 (December, 1974), pp. 303-336; and T.C. Langetieg, "An Application of A Three-Factor Performance Index to Measure Stockholder Gains from Merger" *Journal of Financial Economics*, V. 6 (December, 1978), pp. 365-384.

[42a] Palepu (1986), presented at the Conference on Takeovers and Contests for Corporate Control, Columbia University, November, 1985.

[43a] Marshall E. Blume and Donald B. Keim, "Risk and Return Characteristics of Lower-Grade Bonds" (unpublished paper, The Wharton School, December, 1984).

The Federal Reserve System's own data are inconsistent with the reasons given for its restrictions on the use of debt.

FIGURE 2
Debt-to-Equity Ratios for Non-Financial Corporations: 1961 to 1985



Source: Federal Reserve System [1986]

plus the equity contributed by the acquirer as collateral. This basic structure is the common way that individuals purchase homes; they use the home plus their down payment as collateral for the mortgage. There is nothing inherently unusual in the structure of this contract, although those who would bar the use of high-yield bonds in takeover ventures would have us believe otherwise.

Some might argue that the risk of high-yield bonds used in takeover attempts is "too high." But high-yield bonds are by definition less risky than common stock claims on the same venture. Would these same critics argue that stock claims are too risky and thus should be barred? The risk argument makes logical sense only as an argument that the transactions costs associated with bankruptcy are too high in these ventures or that the promised yields on the bonds are too low and that investors who purchase them will not earn returns high enough to compensate for the risk they are incurring. This argument makes little sense because there is vast evidence that investors are capable of pricing risks in all sorts of other markets. It is inconceivable they are peculiarly unable to do so in the high-yield bond market.

In January 1986 the Federal Reserve Board issued a new interpretation of the margin rules that restricts the use of debt in takeovers to 50 percent or less of the purchase price. This rule reintroduces size as an effective deterrent to takeover. It was apparently motivated by the belief that the use of corporate debt had become abnormally and dangerously high and was threatening the economy.

This assessment is not consistent with the facts. Figure 2 plots three measures of debt use by nonfinancial corporations in the U.S. The debt/equity ratio is measured relative to three bases: market value of equity, estimated current asset value of equity, and accounting book value of equity measured at historical cost.

Although debt/equity ratios were higher in 1985 than in 1961, they were not at record levels. The book value debt/equity ratio reached a high of 81.4 percent in 1984, but declined to 78 percent in 1985. The fact that debt/equity ratios measured on an historical cost basis are relatively high is to be expected, given the previous decade of inflation. Maintenance of the same inflation-adjusted debt/equity ratio in times of inflation implies that the book value ratio must rise because the current value of assets in the denominator of the inflation-adjusted ratio is rising. The current value ratio, which takes account of inflation, fell from 50.7 percent in 1970 to 46.5 percent in 1985. The market-value ratio rose from 54.7 percent in 1970 to 80.5 percent in 1984 and plummeted to 60.8 percent in 1985. The 1985 market-value ratio was 45 percentage points below its 1974 peak of 105.2 percent. In short, the Federal Reserve System's own data are inconsistent with the reasons given for its restrictions on the use of debt.

High-yield bonds were first used in a takeover bid in early 1984 and have been involved in relatively few bids in total. In 1984, only about 12 percent of the $14.3 billion of new high-yield debt was associated with mergers and acquisitions. In 1985, 26 per-

When correctly implemented they [golden parachutes] help reduce the conflicts of interest between shareholders and managers at times of takeover and therefore make it more likely that the productive gains stemming from changes in control will be realized.

cent of the $14.7 billion of new high-yield debt was used in acquisitions.[44] Some of the acquisitions, however, such as the Unocal and CBS offers (both unsuccessful), have received intense attention from the media; and this publicity has fostered the belief that high-yield bonds are widely used in takeovers. Nevertheless, high-yield bonds are an important innovation in the takeover field because they help eliminate mere size as a deterrent to takeover. They have been particularly influential in helping to bring about reorganizations in the oil industry.

Historical default rates on high-yield bonds have been low, but many of these bonds are so new that the experience could prove to be different in the next downturn. Various opponents have proposed regulations or legislation to restrict the issuance of such securities, to penalize their tax status, and to restrict their holding by thrifts, which can now buy them as substitutes for the issuance of nonmarketable commercial loans. These proposals are premature. Policymakers should be wary of responding to the clamor for restrictions by executives who desire protection from the discipline of the takeover market and by members of the financial community who want to restrict competition from this new financing vehicle.

The holding of high-yield bonds by thrifts is an interesting issue that warrants further analyis. The recent deregulation of the banking and thrift industries presents many opportunities and challenges to the thrifts. Elimination of restrictions on interest paid to depositors has raised the cost of funds to these institutions. Thrifts have also received the right to engage in new activities such as commercial lending. Survival requires these institutions to take advantage of some of these new business opportunities.

The organizational costs of developing commerical lending departments in the 3,500 thrifts in the country is substantial. Thousands of new loan officers will have to be hired and trained. The additional wage and training costs and the bad-debt losses that will be incurred in the learning phase will be substantial. High-yield bonds provide a promising solution to this problem. If part of the commercial lending function can be centralized in the hands of investment bankers who provide commerical loans in the form of marketable high-yield debt, the thrifts can substitute the purchase of this high-yield debt for their commercial lending and thereby avoid the huge investment in such loan departments.

The Legitimate Concerns of Managers

Conflicts of Interest and Increased Costs to Managers

The interests of corporate managers are not the same as the interests of corporations as organizations, and conflicts of interest can become intense when major changes in the organization's strategy are required. Competition causes change, and change creates winners and losers, especially in that branch of the managerial labor market called the takeover market.

Managers' private incentives sometimes run counter to overall efficiency. The costs of takeovers have fallen as the legal and financial skills of participants in the takeover market have become more sophisticated, as the restrictions on takeovers imposed by antitrust laws have been relaxed, and as financing techniques have improved. Except for new regulatory constraints on the use of debt, this means that the largest of the Fortune 500 companies are now potentially subject to takeover. The abolition of mere size as a deterrent to takeover is desirable because it has made possible the realization of large gains from reallocating larger collections of assets to more productive uses.

This new susceptibility to takeover has created a new contracting environment for top-level managers. Many managers are legitimately anxious, and it will take time for the system to work out an appropriate set of practices and contracts reflecting the risks and rewards of the new environment. Some of the uncertainty of top-level managers formerly insulated from pressures from the financial markets will fade as they learn how their policies affect the market value of their companies.

The Desirability of Golden Parachutes

Unfortunately, a major component of the solution to the conflict of interest between shareholders and managers has been vastly misunderstood. I am referring to severance contracts that compensate managers for the loss of their jobs in the event of a

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[44] Source: Drexel Burnham Lambert, private correspondence.

It makes no sense to hire a realtor to sell your house and then penalize him for doing so. Yet that is the implication of many of the emotional reactions to control-related severance contracts.

change in control—what have been popularly labeled "golden parachutes."

These contracts are clearly desirable, even when judged solely from the viewpoint of the interests of shareholders; but they are also efficient from a social viewpoint. When correctly implemented they help reduce the conflicts of interest between shareholders and managers at times of takeover and therefore make it more likely that the productive gains stemming from changes in control will be realized. The evidence indicates that stock prices of firms that adopt severance-related compensation contracts for managers on average rise about 3 percent when adoption of the contracts is announced.[45] There is no easy way to tell how much of this could be due to the market interpreting the announcement as a signal that a takeover bid is more likely and how much is due to the reduction in conflict between managers and shareholders over takovers.

At times of takeover, shareholders are implicitly asking the top-level managers of their firm to negotiate a deal for them that frequently involves the imposition of large personal costs on the managers and their families. These involve substantial moving costs, the loss of position, power and prestige, and even the loss of their jobs. Shareholders are asking the very people who are most likely to have invested considerable time and energy (in some cases a life's work) in building a successful organization to negotiate its sale and the possible redirection of its resources.

It is important to face these conflicts and to structure contracts with managers to reduce them. It makes no sense to hire a realtor to sell your house and then penalize him for doing so. Yet that is the implication of many of the emotional reactions to control-related severance contracts. The restrictions and tax penalties imposed on these severance payments by the Deficit Reduction Act of 1984 are unwise interferences in the contracting freedoms of shareholders and managers; and they should be eliminated. Moreover, it is important to eliminate the misunderstanding about the purpose and effects of these contracts that has been fostered by past rhetoric on the topic so that boards of directors can get on with the job of structuring these contracts.

Golden parachutes can also be used to restrict takeovers and to entrench managers at the expense of shareholders. How does one tell whether a particular set of contracts crosses this line?

The key is whether the contracts help solve the conflict-of-interest problem between shareholders and managers that arises over changes in control. Solving this problem requires extending control-related severance contracts beyond the chief executive to those members of the top-level management team who must play an important role in negotiating and implementing any transfer of control. Contracts that award severance contracts to substantial number of managers beyond this group are unlikely to be in the shareholders' interests. The contracts awarded by Beneficial Corp. to 234 of its managers are unlikely to be justified as in the shareholders' interests.[46]

It is particularly important to institute severance-related compensation contracts in situations where it is optimal for managers to invest in organization-specific human capital—that is, in skills and knowledge that have little or no value in other organizations. Managers will not so invest where the likelihood is high that their investment will be eliminated by an unexpected transfer of control and the loss of their jobs. In such situations the firm will have to pay for all costs associated with the creation of such organization-specific human capital, and it will be difficult to attract and retain highly talented managers when they have better opportunities elsewhere. In addition, contracts that award excessive severance compensation to the appropriate group of managers will tend to motivate managers to sell the firm at too low a price.

No simple rules can be specified that will easily prevent the misuse of golden parachutes because the appropriate solution will depend on many factors that are specific to each situation (for example, the amount of stock held by managers, and the optimal amount of investment in organization-specific human capital). In general, contracts that award inappropriately high payments to a group that is excessively large will reduce efficiency and harm shareholders by raising the cost of acquisition and by transferring wealth from shareholders to managers. The generally appropriate solution is to make the control-related severance contracts pay off in a way that is tied to the premium earned by the stockholders. Stock op-

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[45] See R. Lambert and D. Larcker, "Golden Parachutes, Executive Decision-Making, and Shareholder Wealth", *Journal of Accounting and Economics*, V. 7 (April, 1985), pp. 179-204.

[46] Ann Morrison, "Those Executive Bailout Deals," *Fortune*, (December 13, 1982).

> ***Greenmail is the Trojan horse of the takeover battle in the legal and political arenas...Management can easily prohibit greenmail without legislation: it need only announce a policy that, like Ulysses tying himself to the mast, prohibits it from making such payments.***

tions or restricted stock appreciation rights that pay off only in the event of a change in control are two options that have some of the appropriate properties. In general, policies that encourage increased stock ownership by managers and the board of directors will provide incentives that will tend to reduce the conflicts of interests with managers.

Targeted Repurchases

The evidence indicates takeovers generate large benefits for shareholders. Yet virtually all proposals to protect shareholders from asserted difficulties in the control market will harm them by either eliminating or reducing the probability of successful hostile tender offers. These proposals will also block the productivity increases that are the source of the gains.

Most proposals to restrict or prohibit targeted repurchases (transactions pejoratively labeled "greenmail") are nothing more than antitakeover proposals in disguise. Greenmail is an appellation that suggests blackmail; yet the only effective weapon possessed by a greenmailer is the right to offer to purchase stock from other shareholders at a substantial premium. The "damage" to shareholders caused by this action is difficult to find. Those who propose to "protect" shareholders hide this fact behind emotional language designed to mislead. Greenmail is actually a targeted repurchase, an offer by *management* to repurchase the shares of a subset of shareholders at a premium, an offer not made to other shareholders.

Greenmail is the Trojan horse of the takeover battle in the legal and political arenas. Antitakeover proposals are commonly disguised as antigreenmail provisions. Management can easily prohibit greenmail without legislation: it need only announce a policy that, like Ulysses tying himself to the mast, prohibits management or the board from making such payments.[47]

Problems in the Delaware Court

Delaware courts have created over the years a highly productive fabric of corporate law that has benefited the nation. The court is having difficulty, however, in sorting out the complex issues it faces in the takeover area. The court's problems in settling conflicts between shareholders and management over control issues reflect a fundamental weakness in its model of the corporation, a model that has heretofore worked quite well. The result has been a confusing set of decisions that, in contrast to much of the court's previous history, appears to make little economic sense.[49]

Altruism and the Business Judgment Rule

The Delaware court's model of the corporation is founded in the business judgment rule—the legal doctrine that holds that unless explicit evidence of fraud or self-dealing exists the board of directors is presumed to be acting solely in the interests of shareholders....The courts must not apply the business judgment rule to conflicts over control rights between principals and agents. If the business judgement rule is applied to such conflicts, the courts are effectively giving the *agent* (management) the right unilaterally to change the control rights. In the long run, this interpretation of the contract will destroy the possibility of such cooperative arrangements because it will leave principals (stockholders) with few effective rights.

Recently the courts have applied the business judgment rule to the conflicts over the issuance of poison pill preferred stock, poison pill rights, and discriminatory targeted repurchases, and have given managers and boards the rights to use these

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[47] Three excellent studies of these transactions indicate that when measured from the initial toehold purchase to the final repurchase of the shares, the stock price of target firms rises. Therefore, shareholders are benefited, not harmed, by the whole sequence of events. (See Clifford Holderness and Dennis Sheehan, "Raiders or Saviors: The Evidence on Six Controversial Investors," *Journal of Financial Economics* (December, 1985), Wayne H. Mikkelson, and Richard S. Ruback, "An Empirical Analysis of the Interfirm Equity Investment Process," *Journal of Financial Economics*, V. 14 (December, 1985), and Wayne H. Mikkelson and Richard S. Ruback, "Targeted Repurchases and Common Stock Returns", (unpublished manuscript, June, 1986).) There is some indication, however, that the stock price increases might represent the expectation of future takeover premiums in firms in which the targeted repurchase was not sufficient to prevent ultimate takeover of the firm. If so, it may well be that, much as in the final defeat of tender offers found by Bradley, Desai and Kim (Michael Bradley, Anand Desai and E. Han Kim, "The Rationale Behind Interfirm Tender Offers: Information or Synergy?" *Journal of Financial Economics*, V. 11 (April, 1983), pp. 183-206), all premiums are lost to those shareholders in firms for which the repurchase and associated standstill agreements successfully lock up the firm. The evidence on these issues is not yet sufficient to issue a final judgement either way.

[49] See, for example, Moran v. Household Intl. Inc., 490 A.2d 1059 (Del.Ch.1985) aff'd. 500 A.2d 1346 (Del.1985) (upholding poison pill rights issue), Smith v Van Gorkom, 488 A.2d 858, (holding board liable for damages in sale of firm at substantial premium over market price), Unocal v Mesa, 493 A.2d 946, 954 (Del. 1985) (allowing discriminatory targeted repurchase that confiscates wealth of largest shareholder), Revlon Inc. v MacAndrews & Forbes Holdings Inc., 506 A.2nd 173, 180 (Del. 1986), (invalidation of Revlon's lockup sale of a prime division to Forstmann Little at a below-market price).

Rights issues like Household's and Crown Zellerbach's harm shareholders. They will fundamentally impair the efficiency of corporations that adopt them, and for this reason they will reduce productivity in the economy if widely adopted.

devices.[52] In so doing the courts are essentially giving the agents (managers and the board) the right unilaterally to change critical control aspects of the contract—in particular the right to fire the agent. This has major implications for economic activity, productivity, and the health of the corporation. If the trend goes far enough, the corporation as an organizational form will be serioiusly handicapped.

Poison Pills

Poison pill securities change fundamental aspects of the corporate rules of the game that govern the relationship between shareholders, managers, and the board of directors. They do so when a control-related event occurs, such as a takeover offer or the acquisition of a substantial block of stock or voting rights by an individual or group. The Household International version of the poison pill rights issue is particularly interesting because it was a major test case in the area.

When the Household International board of directors issued its complicated right to shareholders, it unilaterally changed the nature of the contractual relationship with Household's shareholders in a fundamental way. The right effectively restricts the alienability of the common stock by prohibiting shareholders from selling their shares, without permission of the board, into a control transaction leading to merger at a price that involves a premium over market value of less than $6 billion. Since Household had a market value of less than $2 billion at the time, this was a premium of over 300 percent—more than 6 times the average takeover premium of 50 percent common in recent times—a premium that is difficult to justify as in the shareholders' interests.

The November 1985 Delaware court decision upholding the Household International rights issue will significantly restrict hostile takeovers of firms that adopt similar provisions. Before that decision, 37 pills of various forms had been adopted. Over 150 corporations adopted pills in the seven months following that decision.[53] Unlike most other antitakeover devices, this defense is very difficult for a prospective acquirer to overcome without meeting the board's terms (at least one who desires to complete the second-step closeout merger). An SEC study analyzed the 37 companies introducing pills between June 1983, when Lenox introduced the first one, and December 1985. Eleven of these 37 firms experienced control changes: five experienced a negotiated change in control while the pill was in effect (Revlon, Cluett Peabody, Great Lakes, Int., Lenox, and Enstar), two were taken over by creeping acquisitions (Crown Zellerbach and William Wright), two were taken over after their pills were declared illegal (AMF and Richardson Vicks), one (Superior Oil) was acquired after the pill was withdrawn in the face of a lawsuit and proxy fight by its largest holder, and one (Amsted) has proposed a leveraged buyout. The SEC study finds that "Announcements of [twenty] poison pill plans in the midst of takeover speculations have resulted in an average 2.4 percent net of market price declines for firms adopting the plans." The effects of another twelve plans adopted by firms that were not the subject of takeover speculation were essentially nil.[53a]

Sir James Goldsmith recently gained control of Crown Zellerbach, which had implemented a rights issue similar to Household International's. Goldsmith purchased a controlling interest in the open market after Crown's board opposed his tender offer and refused to recall its rights issue. In this situation the acquirer must either tolerate the costs associated with leaving the minority interest outstanding and forsake the benefits of merging the assets of the two organizations, or incur the costs of the premium required by the rights on execution of the second-step closeout merger. The Crown case revealed a loophole in the Household/Crown version of the pill (which has been closed in newly implemented versions). Although Goldsmith could not complete a second-step merger without paying the high-premium required by the rights, he could avoid it by simply liquidating Crown.

Rights issues like Household's and Crown Zellerbach's harm shareholders. They will fundamentally impair the efficiency of corporations that adopt them, and for this reason they will reduce

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[52] Moran v Household Intl., and Unocal v Mesa.

[53] See Office of the Chief Economist of the SEC, "The Economics of Poison Pills," (March 5, 1986), and Corporate Control Alert, (February, March and April, May and June, 1986).

[53a] Ibid.

The Unocal victory over Mesa cost the Unocal shareholders $1.1 billion ($9.48 per post-offer share). This is the amount by which the $9.4 billion Mesa offer exceeded the $8.3 billion value of Unocal's "victory."

productivity in the economy if widely adopted.[53b]

A broad interpretation of the business judgment rule is important to the effectiveness of the corporation because a system that puts the courts into the business of making managerial decisions will generate great inefficiencies. The court has erred, however, in allowing the Household board, under the business judgement rule, to make the fundamental change in the structure of the organization implied by the rights issue without votes of its shareholders. It is unlikely the court would allow the board to decide unilaterally to make the organization a closed corporation by denying shareholders the right to sell their shares to anyone at a mutually agreeable price without the permission of the board. The Household International rights issue places just such a restriction on the alienability of shares, but only in the case of a subset of transactions—the control-related transactions so critical for protecting shareholders when the normal internal board-level control mechanisms break down. Several other poison pill cases have been heard by the courts with similar outcomes, but a New Jersey and two New York courts have recently ruled against poison pills that substantially interfere with the voting rights of large-block shareholders.[54] An Illinois District Court recently voided a poison pill (affirmed by the Seventh Circuit Court of Appeals) and two weeks later approved a new pill issued by the same company.[55]

The problem with these special securities and the provision they contain is not with their appropriateness (some might well be desirable), but with the manner in which they are being adopted—that is, without approval by shareholders. Boards of directors show little inclination to refer such issues to shareholders.

One solution to the problems caused by the Household decision is for shareholders to approve amendments to the certificate of incorporation to restrict the board's power to take such actions without shareholder approval. This is not an easy task, however, given the pressure corporate managers are bringing to bear on the managers of their pension funds to vote with management.[56] Even more problematic is the provision in Delaware law that requires certificate amendments to be recommended to shareholders by the board of directors.[57]

Exclusionary Self Tenders: The Unocal v. Mesa Decision[58]

The Delaware Supreme Court surprised the legal, financial, and corporate communities in the spring of 1985 by giving Unocal the right to make a tender offer for 29 percent of its shares while excluding its largest shareholder, Mesa Partners II, from the offer. This decision enabled the Unocal management and board to avoid loss of control to Mesa. The decision imposed large costs on Unocal shareholders and, if not reversed, threatens major damage to shareholders of all Delaware corporations.

The Unocal victory over Mesa cost the Unocal shareholders $1.1 billion ($9.48 per post-offer share). This is the amount by which the $9.4 billion Mesa offer exceeded the $8.3 billion value of Unocal's "victory."[59] This loss represents 18 percent of Unocal's pre-takeover value of $6.2 billion. The $2.1 billion net increase in value to $8.3 billion resulted from Unocal's $4.2 billion debt issue which, contrary to assertions, benefits its shareholders. It does so by effectively bonding Unocal to pay out a substantial fraction of its huge cash flows to shareholders rather than to reinvest them in low-return projects, and by reducing taxes on Unocal and its shareholders.

For his services in generating this $2.1 billion gain for Unocal shareholders, T. Boone Pickens has

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[53b] Another study of the effects of poison pills (Paul H. Malatesta and Ralph A. Walkling, "The Impact of Poison Pill Securities on Stockholder Wealth," (unpublished, University of Washington, 1985) also indicates they have a negative effect on stock prices. On average, stock prices fell by a statistically significant 2 percent in the 2 days around the announcement in the *Wall Street Journal* of adoption of a poison pill for a sample of 14 firms that adopted these securities between December 1982 and February 1985. This price decline, however, was smaller than the average 7.5 percent increase in price that occurred in the 10 days prior to the adoption of the pill. Firms adopting pills appear to be those in which managers and directors bear a substantially smaller fraction of the wealth consequences of their actions. In all but three of the firms the percentage of common shares owned by officers and directors was substantially below the industry average ownership of shares. The average ownership of firms in the same industry was 16.5 percent and for the firms adopting pills it was 7.5 percent.

[54] Minstar Acquiring Corp. v AMF Inc., 621 Fed Sup 1252. So Dis NY, 1985, Unilever Acquisition Corp. v Richardson-Vicks, Inc., 618 Fed Supp 407. So Dist. NY 1985, Asarco Inc. v M.R.H. Holmes a Court, 611 Fed Sup 468. Dist Ct of NJ, 1985, and Dynamics Corp. of America v CTS Corporation.

[55] Dynamics Corp. of America v. CTS Corp., *et al.* U.S. District Court, Northern District of Illinois, Eastern Division, No. 86 C 1624, (April 17, 1986), affirmed Seventh Circuit Court of Appeals Nos. 86-16-1, 86-1608, and Dynamics Corp. of America v. CTS Corp., *et al.* (May 3, 1986).

[56] See Joe. Koleman, "The Proxy Pressure on Pension Fund Managers", Institutional Investor, (July, 1985), pp. 145-147, and Investor Responsibility Research Center, Inc., Corporate Governance Service: Voting by Institutional Investors on Corporate Governance Questions, 1985 Proxy Season, pp. 19-25.

[57] 8 *Del. C.* 242(c)(1).

[58] This discussion is based on my article, "When Unocal Won over Pickens, Shareholders and Society Lost," *Financier*, V. IX, No. 11 (Nov., 1985), pp. 50-53.

[59] The $8.3 billion value of Unocal securities held by its shareholders is calculated as $4.1 billion in stock (116 million shares at $34 7/8 on May 24, the first trading day after close of the offer), and $4.2 billion in Unocal debt trading at $75.50.

In addition to Mesa's losses, shareholders of all Delaware corporations lose because the court's decision gives management a weapon so powerful it essentially guarantees that no Delaware corporation that uses it will be taken over by a tender offer.

been vilified in the press, and Mesa Partners II has incurred net losses before taxes—obviously a perversion of incentives.

In addition to Mesa's losses, shareholders of all Delaware corporations lose because the court's decision gives management a weapon so powerful it essentially guarantees that no Delaware corporation that uses it will be taken over by a tender offer. A determined board could, in the extreme, pay out all the corporation's assets and leave the acquirer holding a worthless shell. Because of this new power, shareholders are denied the benefits of future actions by Pickens and others to discipline managers whose strategies are wasting resources.

Society also loses. The decision will have a chilling effect on takeovers, blocking the productivity increases that are the source of the takeover gains and thereby handicapping Delaware corporations in the competition for survival.

Unocal's self-tender for 29 percent of its shares at $72 per share ($26 over the market price) was designed to defeat Mesa's $54 per share cash offer for 50.4 percent of Unocal's shares plus $54 per share in debt securities for the remaining 49.6 percent. The Unocal offer would have paid 59 percent of Unocal's pretakeover equity to other shareholders while denying participation to the 13.6 percent minority holding of Mesa Partners II. This would transfer about $248 million from Mesa's holdings to other Unocal stockholders—a classic case of corporate raiding that contrasts with the beneficial effects of the actions of takeover specialists like Pickens, Carl Icahn and Irwin Jacobs on other shareholders.

Faced with the threat of legalized expropriation of $248 million, Mesa accepted a settlement in which Unocal backed off from the Mesa exclusion. The settlement involved repurchase of part of Mesa's shares at the terms of the tender offer, a 25-year standstill agreement, a promise to vote its shares in the same proportion as other shares are voted, and constraints on Mesa's rights to sell its remaining shares.

The essential characteristics of Unocal's exclusionary repurchase defense are now incorporated in newly popular poison pill plans called back-end plans.[60] These plans give shareholders a right to tender their shares for securities worth more than the market value of their stock when a shareholder exceeds a certain maximum limit of stock ownership that ranges from 30 to 50 percent. As with Unocal's exclusion of Mesa, the large shareholder is denied the same right to tender his shares. This threatens a shareholder who violates the holding limit with potentially large dilution of his holdings. It thereby limits the existence of large stock holdings.

"Protection" From Two-Tier Tender Offers. The court ruled that the objective of Unocal's offer was to protect its shareholders against "a grossly inadequate and coercive two-tier, front-end-loaded tender offer" and against greenmail. This assessment of the situation was upside down. Paradoxically, the court's ruling imposed on Unocal shareholders exactly the evil it purported to prevent. Unocal defeated Mesa's $1.1 billion higher offer precisely because Mesa's offer was a level $54 offer and Unocal's offer was an extreme front-end loaded two-tier offer—$72 for 29 percent of its shares in the front-end with a back-end price of $35 for the remaining 71 percent of the shares. (The back-end price was implicit, but easy to calculate and reported in the press at the time of the offer.) The effective price of the Unocal offer was therefore only $45.73 per pre-offer share (the weighted average of the front- and back-end prices).

Comparing the Unocal offer with SEC estimates of average minimums in two-tier tender offers indicates the extreme nature of the Unocal two-tier offer. Historically the average back-end premium on outside two-tier offers is 45 percent higher than the stock price measured 20 trading days prior to the offer.[61] This contrasts sharply with the *negative* back-end premium on Unocal's self tender of -25 percent. That is, the $35 back-end price was 25 percent below the Unocal market price of $46 3/8 twenty days before the offer.

The negative back-end premium on Unocal's offer means the holders of 20 million Unocal shares who failed to tender to the first tier of the Unocal offer were particularly hurt. As of the close of the offer they suffered total losses of $382 million, $215 million from the loss of $37.12/share on 29 percent of their shares,[62] plus a loss of $167 million from being denied the $54 in debt securities they would have received in

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[60] See Office of the Chief Economist of the SEC, "The Economics of Poison Pills" (March 5, 1986).

[61] See Comment, Robert, and Gregg A. Jarrell, "Two-Tier Tender Offers: The Imprisonment of the Free-Riding Shareholder," (unpublished manuscript, March 1, 1986); an earlier version appeared as Office of the Chief Economist, Securities and Exchange Commission, "The Economics of Any-or-All, Partial, and Two-Tier Tender Offers," *Federal Register*, June 29, 1984, pp. 26,751-26,761.

[62] Calculated as the $72 value of the Unocal debt offered in exchange for 29% of their shares less the $34.875 post-offer closing price of the shares.

Responsible boards of directors interested in the welfare of shareholders and the survival of the corporation as an organizational form will implement procedures to ban all targeted repurchases that carry premiums over market value.

the back end of the Mesa offer.[63]

Protection From Targeted Repurchases. The court also erred in its concern over greenmail. In ruling to eliminate the threat of greenmail, the court in fact authorized Unocal to make a greenmail transaction that differs from the usual variety only in that it penalized, rather than benefited, the large-block holder (i.e., reverse greenmail). In authorizing this form of targeted repurchase, the court granted large benefits to managers who desire protection from competition but harmed shareholders.

One of the great strengths of the corporation is the long-held principle that holders of a given class of securities are treated identically in transactions with the corporation. The Unocal decision threatens to turn the corporation into a battleground where special-interest groups of shareholders fight over the division of the pie much as special interests in the public sector do. The result will be a much smaller pie.

Responsible boards of directors interested in the welfare of shareholders and the survival of the corporation as an organizational form will implement procedures to ban all targeted repurchases that carry premiums over market value

Conclusion

Although economic analysis and the evidence indicate the market for corporate control is benefiting shareholders, society, and the corporation as an organizational form, it is also making life more uncomfortable for top-level executives. This discomfort is creating strong pressures at both the state and federal levels for restrictions that will seriously cripple the workings of this market. In 1985 there were 21 bills on this topic in the Congressional hopper, all of which proposed various restrictions on the market for corporate control. Some proposed major new restrictions on share ownership and financial instruments. Within the past several years the legislatures of numerous states have passed antitakeover laws. This political activity is another example of special interests using the democratic political system to change the rules of the game to benefit themselves at the expense of society as a whole. In this case the special interests are top-level corporate managers and other groups who stand to lose from competition in the market for corporate control. The result will be a significant weakening of the corporation as an organizational form and a reduction in efficiency.

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[63] See Michael Bradley and Michael Rosenzweig, "The Law and Economics of Defensive Stock Repurchases and Defensive Self-Tender Offers," (Unpublished manuscript, University of Michigan, 1985) for a thorough discussion of the issues involved in self tender offers.

APPENDIX: Evidence From Financial Transactions in Support of the Free Cash Flow Theory of Mergers

Free cash flow theory helps explain previously puzzling results on the effects of various financial transactions. Smith [1986]* summarizes more than twenty studies of stock price changes at announcements of transactions that change capital structure as well as various other dividend transactions. These results are summarized in Table 2.

For firms with positive free cash flow, the theory predicts that stock prices will increase with unexpected increases in payouts to shareholders and decrease with unexpected decreases in payouts. It also predicts that unexpected increases in demand for funds from shareholders via new issues will cause stock prices to fall. In addition, the theory predicts stock prices will increase with increasing tightness of the constraints binding the payout of future cash flow to shareholders and decrease with reductions in the tightness of these constraints. These predictions do not apply, however, to those firms with more profitable projects than free cash flow to fund them.

The predictions of the agency cost of free cash flow are consistent with all but three of the 32 estimated abnormal stock price changes summarized in Table 2. Moreover, one of the inconsistencies is explainable by another phenomenon.

Panel A of Table 2 shows that stock prices rise by a statistically significant amount with announcements of the initiation of cash dividend payments, increases in dividends, and payments of specially designated dividends; they fall by a statistically significant amount with decreases in dividend payments. (All coefficients in the table are significantly different from zero unless noted with an asterisk.)

Panel B of Table 2 shows that security sales and

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*See Cliff Smith, "Investment Banking and the Capital Acquisition Process," *Journal of Financial Economics* 15 (1986) for references to all studies cited in this Appendix.

TABLE 2
The Stock Market Response to Various Dividend and Capital Structure Transactions

Summary of two-day average abnormal stock returns associated with the announcement of various dividend and capital structure transactions.

Returns are weighted averages, by sample size, of the returns reported by the respective studies. All returns are significantly different from zero unless noted otherwise by .*

Type of Transaction	Security Issued	Security Retired
PANEL A: Dividend changes that change the cash paid to shareholders		
Dividend initiation[1]		
Dividend increase[2]		
Specially designated dividend[3]		
Dividend decrease[2]		
PANEL B: Security sales (that raise cash) and retirements (that pay out cash) and simultaneously		
Security sale (industrial)[4]	debt	none
Security sale (utility)[5]	debt	none
Security sale (industrial)[6]	preferred	none
Security sale (utility)[7]	preferred	none
Call[8]	none	debt
PANEL C: Security sales which raise cash and bond future cash flow payments only minimally		
Security sale (industrial)[4]	conv. debt	none
Security sale (industrial)[6]	conv. preferred	none
Security sale (utility)[7]	conv. preferred	none
PANEL D: Security retirements that pay out cash to shareholders		
Self tender offer[9]	none	common
Open market purchase[10]	none	common
Targeted small holdings[11]	none	common
Targeted large block repurchase[12]	none	common
PANEL E: Security sales or calls that raise cash and do not bond future cash flow payments		
Security sale (industrial)[13]	common	none
Security sale (utility)[14]	common	none
Conversion-forcing call	common	conv. preferred
Conversion-forcing call	common	conv. debt
PANEL F: Exchange offers, or designated use security sales that increase the bonding of payout of		
Designated use security sale	debt	common
Exchange offer	debt	common
Exchange offer	preferred	common
Exchange offer	debt	preferred
Exchange offer	income bonds	preferred
PANEL G: Transaction with no change in bonding of payout of future cash flows		
Exchange offer	debt	debt
Designated use security sale	debt	debt
PANEL H: Exchange offers, or designated use security sales that decrease the bonding of payout		
Security sale	conv. debt	debt
Exchange offer	common	preferred
Exchange offer	preferred	debt
Security sale	common	debt
Exchange offer	common	debt

[1] Asquith and Mullins (1983).
[2] Calculated by Smith (1986, Table 1) from Charest (1978), and Aharony and Swary (1980).
[3] From Brickley (1983).
[4] Calculated by Smith (1986, Table 1) from Dann and Mikkelson (1984), Eckbo (1986), Mikkelson and Partch (1986).
[5] Eckbo (1986).
[6] Calculated by Smith (1986, Table 1) from Linn and Pinegar (1985), Mikkelson and Partch (1986).
[7] Linn and Pinegar (1985).
[8] Vu (1986).
[9] Calculated by Smith (1986, Table 1) from Dann (1981), Masulis (1980), Vermaelen (1981), Rosenfeld (1982).
[10] Dann (1980), Vermaelen (1981).
[11] Bradley and Wakeman (1983).
[12] Calculated by Smith (1986, Table 4) from Dann and DeAngelo (1983), Bradley and Wakeman (1983).
[13] Calculated by Smith (1986, Table 1) from Asquith and Mullins (1986), Kolodny and Suhler (1985), Masulis and Korwar (1986) Mikkelson and Partch (1986), Schipper and Smith (1986).

retirements that raise cash or pay out cash and simultaneously provide offsetting changes in the constraints bonding the payout of future cash flow are all associated with returns insignificantly different from zero. The insignificant return on retirement debt fits the theory because the payout of cash is offset by an equal reduction in the present value of promised future cash payouts. If the debt sales are associated with no changes in the expected investment program, the insignificant return on announcements of the sale of debt and preferred also fits the theory. The acquisition of new funds with debt or preferred

Average Sample Size	Average Abnormal Two-Day Announcement Period Return	Sign Predicted by Free Cash Flow Theory	Agreement with Free Cash Flow Theory?	Agreement with Tax Theory
160	3.7%	+	yes	no
281	0.9	+	yes	no
164	2.1	+	yes	no
48	−3.6	−	yes	no
provide off-setting changes in the constraints bonding future payment of cash flows.				
248	−0.2*	0	yes	no
140	−0.1*	0	yes	no
28	−0.1*	0	yes	yes
249	−0.1*	0	yes	yes
133	−0.1*	0	yes	no
74	−2.1	—	yes	no
54	−1.4	—	yes	no
9	−1.6	—	yes	no
147	15.2	+	yes	yes
182	3.3	+	yes	yes
15	1.1	+	yes	yes
68	−4.8	+	no**	no**
215	−3.0	—	yes	yes
405	−0.6	—	yes	yes
57	−0.4*	—	no	yes
113	−2.1	—	yes	yes
future cash flows				
45	21.9	+	yes	yes
52	14.0	+	yes	yes
9	8.3	+	yes	no
24	3.5	+	yes	yes
18	1.6	+	yes	yes
36	0.6	0	no	no
96	0.2*	0	yes	yes
of future cash flows				
15	−2.4	—	yes	yes
23	−2.6	—	yes	no
9	−7.7	—	yes	yes
12	−4.2	—	yes	yes
81	−1.1	—	yes	yes

[16] Calculated by Smith (1986, Table 1) from Asquith and Mullins (1986), Masulis and Korwar (1986), Pettway and Radcliffe (1985).

[17] Masulis (1980).

[18] Masulis (1983). These returns include announcement days of both the original offer and, for about 40 percent of the sample, a second announcement of specific terms of the exchange.

[19] McConnell and Schlarbaum (1981).

[20] Dietrich (1984).

[21] As calculated by Smith (1986, Table 3) from Eckbo (1986), Mikkelson and Partch (1986).

[22] Mikkelson (1981).

[23] Rogers and Owers (1985, Peavy and Scott 1985, Finnerty 1985).

* Not statistically different from zero.

** Explained by the fact that these transactions are frequently associated with the termination of an actual or expected control bid. The price decline appears to reflect the loss of an expected control premium.

is offset exactly by a commitment bonding the future payout of cash flows of equal present value.

Panel C shows that sales of convertible debt and convertible preferred are associated with significantly negative stock price changes. These security sales raise cash and provide little effective bonding of future cash flow payments for the following reason: when the stock into which the debt is convertible is worth more than the face value of the debt, management has incentives to call them and force conversion to common.

Panel D shows that, with one exception, security retirements that pay out cash to shareholders increase stock prices. The price decline associated with targeted large block repurchases (often called "greenmail") is highly likely to be due to the reduced probability that a takeover premium will be realized. These transactions are often associated with standstill agreements in which the seller of the stock agrees to refrain from acquiring more stock and from making a takeover offer for some period into the future.

Panel E summarizes the effects of security sales and retirements that raise cash and do not bond future cash flow payments. Consistent with the theory, negative abnormal returns are associated with all such changes. However, the negative returns associated with the sale of common through a conversion-forcing call are statistically insignificant.

Panel F shows that all exchange offers or designated-use security sales that increase the bonding of payout of future cash flows result in significantly positive increases in common stock prices. These include stock repurchases and exchange of debt or preferred for common, debt for preferred, and income bonds for preferred. The two-day gains range from 21.9 percent (debt for common) to 2.2 percent (debt or income bonds for preferred).

Panel G of Table 2 shows that the evidence on transactions with no cash flow and no change in the bonding of payout of future cash flows is mixed. The returns associated with exchange offers of debt for debt are significantly positive, and those for designated-use security sales are insignificantly different from zero.

Panel H of Table 2 shows that all exchanges, or designated-use security sales that have no cash effects but reduce the bonding of payout of future cash flows result, on average, in significant decreases in stock prices. These transactions include the exchange of common for debt or preferred or preferred for debt, or the replacement of debt with convertible debt. The two-day losses range from −9.9% (common for debt) to −2.4% (for designated-use security sale replacing debt with convertible debt).

In summary, the results in Table 2 are remarkably consistent with free cash flow theory, which predicts that, except for firms with profitable unfunded investment projects, prices will rise with unexpected increases in payouts to shareholders (or promises to do so) and will fall with reductions in payments or new requests for funds from shareholders (or reductions in promises to make future payments). Moreover, the size of the value changes is positively related to the change in the tightness of the commitment bonding the payment of future cash flows. For example, the effects of debt-for-preferred exchanges are smaller than the effects of debt-for-common exchanges.

Tax effects can explain some of these results, but not all—for example, the price changes associated with exchanges of preferred for common or replacements of debt with convertible debt, neither of which which have any tax effects. The last column of Table 2 denotes whether the individual coefficients are explainable by these pure corporate tax effects. The tax theory hypothesizes that all unexpected changes in capital structure which decrease corporate taxes increase stock prices and vice versa.[34] Therefore, increases in dividend and reductions of debt interest should cause stock price to fall and vice versa.[35] Thirteen of the 32 coefficients are inconsistent with the corporate tax hypothesis. Simple signaling effects, where the payout of cash signals the lack of present and future investments that promise returns in excess of the cost of capital, are also inconsistent with the results—for example, the positive stock price changes associated with dividend increases and stock repurchases.

If anything, the results in Table 2 seem too good. The returns summarized in the table do not distinguish firms that have free cash flow from those that do not have free cash flow. Yet the theory tells us the returns to firms with no free cash flow will behave differently from those which do. In addition, only unexpected changes in cash payout or the tightness of the commitments bonding the payout of future free cash flows should affect stock prices. The studies summarized in Table 2 do not, in general, control for the effects of expectations. If the free cash flow effects are large and if firms on average are in a positive free cash flow position, the predictions of the theory will hold for the simple sample averages. If the effects are this pervasive, the waste due to agency problems in the corporate sector is greater than most scholars have thought. This helps explain the high level of activity in the corporate control market over the last decade. More detailed tests of the propositions that control for growth prospects and expectations will be interesting.

THE AMERICAN LAWYER

HEADNOTES

BY STEVEN BRILL

The Roaring Eighties

In the midst of his stormy battle for control of Phillips Petroleum, New York takeover artist Carl Icahn offered a revelation right out of a Hollywood script: "[T]here was a fellow, somebody that calls me up every once in a while, and . . . says he represents some tremendous money. . . . And I have no idea who the hell it is," Icahn recalled in a February 19 deposition, the contents of which have, until now, been sealed. "He has my private phone number," Icahn continued. "I don't know how the hell he got it. . . . And he called me once in January when I went down to Palm Beach. . . . He seemed to know where the hell I was, and everything. The thing interesting about it was that he seemed to know a lot of things that are going on. I have no idea how he knows it."

Icahn went on to testify that the phantom had been calling since the early 1980s and had provided important information and encouragement during a string of takeover battles that has seen Icahn take gutsy stock positions in various companies only to be bought out by competing bidders or in "greenmail" payments by management. The phantom, Icahn stated, seemed "to know too much. . . . I mean during the period with the whole OPEC thing, with oil up and down . . . he seemed to be able to predict what the oil prices would be, what was going to happen at the OPEC meetings. . . ."

According to Icahn, one reason he persevered in his ultimately profitable battle with Phillips was that his caller said he'd buy out Icahn's Phillips stock if Icahn found himself stuck with it. "This guy . . . said his group, [a] very big group [with] big power, is going to make an offer for my stock. So I said, 'Who the hell are you?' He said, 'When the time comes, you will know.' . . . He didn't give me inside information about the company but he knows the facts backwards and forwards about the company. . . . Normally, I wouldn't talk to people like this, but there is something about it that makes me stay with it. Plus it helped me in Marshall Field [one of Icahn's most celebrated raids], so I do it. . . ."

The caller promised, Icahn continued, that " 'as much money as you have and can raise, it is nothing compared to what we can do.'

"[T]he only reason that I . . . lend some credence to it," Icahn reiterated, "is that he really knows the company. . . .I pride myself in being an analyst. . . .I think I know Phillips probably better than anybody outside of Phillips and probably a lot better than many of those inside. This guy knows it better than I do. . . . He knows a lot more than any arbitrageur would. . . ."

Bizarre stuff, this account from the man who this winter destabilized the nation's sixteenth-largest publicly held industrial company by threatening to float the largest financing in takeover history, and who is part of a pack of what detractors call "takeover entrepreneurs" who seem to create wealth out of nothing for shareholders and themselves, while terrorizing a group of establishment executives, many of whom, says Icahn, "only come off the golf course when I buy their stock." And it would, indeed, make a terrific script—the all-knowing, all-powerful voice on the phone guides our straight-talking, anti-establishment, up-from-the-streets-of-Queens hero as he brings arrogant, bloated managements to their knees, all on behalf of the forgotten shareholders.

If that seems fanciful, there's still more in the Phillips takeover fight worthy of a good screenwriter. In fact, the whole Phillips episode seems to be part of, or maybe the embodiment of, a fantasy era we now seem to be living. Were it a soap opera, we could call it *The Roaring Eighties*.

In *The Roaring Eighties* everyone gets rich quick. In *The Roaring Eighties* credit is there for the asking because the era's magic word—leverage—is always a good thing. In *The Roaring Eighties* there are no nervous Nellies at the SEC worrying about fraudulent or incomplete filings or insider tipping, because, again, everyone is getting rich. In *The Roaring Eighties* 30- and 40-year-old money managers who think in time horizons of two hours to two weeks control industrial America. In *The Roaring Eighties* "independent" lawyers call people like Icahn extortionists and racketeers in one brief, then call him a hero in the next writing, after he's hired them. In *The Roaring Eighties* many "independent" investment bankers act with all the independence and loyalty of ladies of the night. But nobody cares much because, again, everyone is having a terrific time and getting filthy rich.

Yet even with all the fun and games, this soap opera is dead serious stuff, and it may not have a happy ending. Because what's really going on here—what went on in the Phillips brouhaha—is that the forces and people that shape American and world business are undergoing a fundamental shift and steering us into an uncertain future. Thus, among the characters in *The Roaring Eighties* are an insistent bunch of party poopers who complain with what some think is annoying persuasiveness that *The Roaring Eighties* will end like the Roaring Twenties

Let's look in on the action:

1. OPENING BID FROM THE SEDUCTIVE TEXAN

On December 4, 1984, an affiliate of Mesa Petroleum, a small, Amarillo, Texas–based oil company run by a folksy character named T. Boone Pickens, announces that it has acquired 5.8 percent of the shares of Phillips Petroleum, and that it will soon begin a tender offer to buy another 14.9 percent of the shares for $60 each. The Phillips stock is selling today for $44. Although Mesa is a about one thirty-seventh the size of Phillips, its takeover threat seems to be real. Why? Leverage!

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Pickens sits at Mesa behind a barbed-wire net of anti-takeover protection devices, plus a fabulous golden parachute at the ready should the protection fail. In other words, in a rational world he'd be cast as a selfish, entrenched manager. Yet he has instead become the media's favorite liberator of oil companies plagued by entrenched managers; and his bid is generally played in the press as a $60-per-share offer that will give Phillips shareholders the value that its management has withheld. This, we shall see, is a man who has managed to turn a Texas drawl, a gift for a great quote, and near-total press *accessibility* into near-total press *credibility.*

Pickens declares that once he buys the additional 14.9 percent he will try to gain control of Phillips, and that if he succeeds he will then propose a merger or some other combination, in which the remaining 79.3 percent of the shareholders will receive some unspecified combination of cash and securities having a value "approximately equal" to $60 per share as determined by "independent bankers selected by [Mesa]." He goes on to say that Mesa has "not formulated any specific proposal" and that "there is no assurance that any such transaction will be proposed."

If that reads like a $60 offer for a $37 stock, read it again. Pickens is promising no transaction at all beyond his tender offer for 14.9 percent of the shares, and he's saying that if there *is* a transaction it will be one full of debentures that his "independent" bankers will value at approximately $60.

Nonetheless, based on Wall Street's belief in the Texan's magic touch the stock shoots up to $48 by the end of the day, and to $53.50 the next day.

Pickens also promises the press and the Street that he'll never take greenmail—a special buyout of his stock to get him to go away—because he's in this fight on behalf of all the shareholders.

2. THE RESCUE SQUAD

Phillips CEO William Douce, 65, is a gruff, no-nonsense (and some say dictatorial) plodder who has worked his way up through the ranks. As Pickens is quick to point out, Douce presides over a company whose stock has been trading at an aggregate value of about $5 billion. Yet its book value—the value of its assets including its oil reserves—is something over $10 billion.

The stock has been trading low, we will hear Pickens (and later Icahn) argue, because Phillips is a sleepy, poorly run company that is deploying its assets badly.

The stock is down, we will hear Douce's team argue, because oil exploration and other long-term ventures have their ups and downs and don't always show up in stock prices over the short term.

They're both probably right.

After hearing of Pickens's bid, Douce leaves the soon-to-be-celebrated Phillips headquarters town of Bartlesville, Oklahoma, and repairs to New York, where he assembles a fight team of bankers from Morgan Stanley and First Boston. Morgan Stanley is to get up to $20 million if Pickens is fended off, but only $2 million if he wins; First Boston is to get up to $15 million if Pickens is defeated and only $4 million if he isn't.

Counsel also need to be hired. But Douce finds he can't turn to Joseph Flom of Skadden, Arps, Slate, Meagher & Flom, whom he has long had on retainer, because Flom has also worked for Pickens. Citing the conflict, Flom bows out of the fight. (Investment bankers are obviously more in the swing of things in *The Roaring Eighties* than lawyers: Morgan Stanley gladly takes on the Phillips business and begins the attack on Pickens, who is a former client.)

Instead of Flom and Skadden, Arps, Douce hires Martin Lipton and his troops from Wachtell, Lipton, Rosen & Katz. This, we will see, is fortuitous to our plot development. In the past Lipton's and Flom's firms were seemingly interchangeable in takeover fights; neither seemed to care much which side it took. But now, with this fight, Lipton crowns his firm as a raider defense specialty house, the unquestioned market leader in such exotic wares as the "poison pill." Flom, on the other hand, hates the pill and says he won't use it.

Lipton is like a quarterback calling audibles from scrimmage. State and federal suits are filed in Delaware, Oklahoma, and Louisiana. Complaints are filed with the Federal Trade Commission, the Securities and Exchange Commission, and the Department of Justice. None of it is likely to work, Lipton tells his numbed client, but it may buy some time. The claims include the charge that Pickens's "$60 offer" is fraudulently illusory—which it may be, but which no one from the Phillips side ever tests by agreeing to Pickens's repeated requests to sit down and discuss the details of his "back-end" offer to the remaining 79 percent of the shareholders. "We told them we could take the whole company out at $60," says Pickens. "But they were afraid to talk to us. They knew we could do it."

When a board meeting is held to reject the Pickens offer and adopt a slew of anti-takeover bylaws, the minutes read quite a bit like the paper record that Lipton's how-to-do-it articles and memos recommend to boards fighting a takeover.

In fact, as we watch the team of bankers and lawyers going to work, it seems that Phillips has already been taken over—by them. As one Phillips executive will later recall, "From the minute Boone struck, Marty Lipton, with help from Joe Fogg [of Morgan Stanley], and Arthur Reichstetter [of First Boston], were running this company. They were leading Bill [Douce] around by the nose. Writing his press releases. Telling him what kinds of stock and notes to issue. Telling him what to say and to whom. Telling him what to divest."

Lipton's people also claim in one suit that in the past Pickens has tipped off his friends at the Amarillo Country Club about some of his raids so that they could buy the stock beforehand. This claim, like the others, isn't likely to win an injunction, though it should be noted that when the Wachtell, Lipton lawyers, who had brought the suit only on rumor, begin taking depositions from Pickens's friends, they find two men who admit buying stock or options before Pickens announced raids. But the two maintain that the purchases weren't based on tips from Pickens, and Pickens vehemently denies that he tipped off any friends. "In Amarillo, Texas, there are as many amateur arbitrageurs as anyplace in the world," Pickens says. "I can't tell you that some people didn't buy any of those stocks. But why would I tip them off?"

3. THE RESCUE PLAN

It is Sunday, December 23. After more than a week of meetings and negotiations with Pickens (in which Flom acts as an intermediary), Lipton and crew come up with a complicated plan that the Phillips board dutifully approves.

The scheme, called a recapitalization plan, would give shareholders a new package of debentures supposedly worth $60 a share for 38 percent of their stock and allow them to sell $1 billion worth of other shares back to the company for as much as $50 per share, in cash. Moreover, new shares totaling 32 percent of the stock would be issued—in lieu of some future employee wage increases—to an employee stock ownership trust, which presumably would forever vote in favor of management. When combined with other friendly shares, this employee stock trust would give management effective control over the company.

Where's Phillips going to get the money to buy back those shares and support all that new debt? Easy: The company is going to sell $2 billion worth of unspecified assets and cut capital expenditures—this. from a company that had attacked Pickens's bid because it would cause Phillips to sell off assets and cut long-term capital expenditures, and a company that had spent more than $3 billion in recent years to make Douce and crew's empire bigger. by buying General American Oil and R.J. Reynolds's Aminoil subsidiary.

Phillips also announces that although it's not interested in a sale to anyone. it will put aside its recapitalization plan and take $62 a share in cash for all shares if anyone is interested.

When Phillips announces the plan, it claims the package is worth $53 a share—which is better than Pickens's $60, they say, because his bid is illusory.

As for Pickens, there's an announcement about him, too: He's agreed to take a $53 deal from Phillips for the stock he's already bought. Only there's one catch: Pickens, despite his repeated protests that he'll never take greenmail or any other deal not offered to all the shareholders, is guaranteed the $53 in *cash*. Plus he's been given $25 million in "expenses" he's supposedly incurred in mounting his now-aborted effort.

Mesa's T. Boone Pickens: Taking greenmail while attacking greenmail.

At Mesa, Pickens enjoys a barbed-wire net of anti-takeover devices and a golden parachute, yet he is cast by the media as the liberator of oil companies plagued by entrenched managers.

Thus, Pickens has made a quick $89-million profit on his purchase of Phillips stock. Moreover, because he has also bargained for all litigation to be dropped, he has avoided any possible embarrassment from wide disclosure of the depositions suggesting tipping or insider trading.

On the heels of the announcement of the Pickens buyout and the recapitalization plan. Phillips stock plummets from $54.88 to $45.25.

Although Wall Street analysts quickly set a value of $45 to $50 on the recapitalization package and the stock hovers at $45 to $46, Pickens maintains, with a straight face, that his $53 cash sellout is not greenmail but only a different form of the same deal offered all the shareholders. (One of the great features of our soap opera is the ability of so many people to keep straight faces in situations like these.)

Phillips and Pickens are quickly sued in a shareholder class action. Among the complaint's more persuasive points is that the Phillips board had said it would take $62. yet when Pickens offered $60 for some of the shares. the board was not willing even to sit down with him to see if it could get him to offer $60 (or $61 or $62) in cash or its verifiable equivalent for all the shares. In effect. as one arbitrageur later put it. the board had instead said to the shareholders. "We think the stock is worth $62; we won't listen to his $60 to see if it's real; and we want to force you to take what we say is $53 from us in a package that the market says is really worth $45 and that. with the employee trust getting so much stock, forever forecloses the possibility of another bid."

But the suit in Delaware state court is doomed; the law there is that a board of directors can exercise its "business judgment" pretty much as it sees fit as long as it's not grossly negligent.

4. ENTER ICAHN

In *The Roaring Eighties* Carl Icahn's résumé reads like the model career path: He started out as a stock trader, graduated to arbitrage, and then decided that rather than take arbitrage risks anticipating other people's raids he'd gamble on a sure thing—that *he* would do a raid. That is, he'd buy stock and watch it jump as he threatened a takeover.

Phillips's William Douce: His defense team took over the company.

As Icahn enters center stage. the camera flashes back to a confidential memo he wrote in order to recruit prospective partners in 1980 (which was one of the exhibits in a court record recently unsealed at the request of *The American Lawyer*). In the memo Icahn summarizes his *modus operandi:*

> It is our opinion that the elements in today's economic environment have combined in a unique way to create large profit-making opportunities with relatively little risk. . . . It is our contention that sizable profits can be earned by taking large positions in "under valued" stocks and then attempting to control the destinies of the companies in question by:

> a) trying to convince management to liquidate or sell the company to a 'white knight';
> b) waging a proxy contest, or:
> c) making a tender offer and/or:
> d) selling back our position to the company.

"Icahn & Co., Inc., has already utilized these maneuvers successfully three times during the past two years," the memo continues, pointing out that the returns on capital from these "maneuvers" had so far been 100 to 250 percent.

By now, five years later, the several dozen partners whom Icahn recruited for various forays with memos like this one include a small circle of ever-richer relatives, close friends active in garment-center and other small businesses in New York, and other stock speculators—including Cincinnati-based Marvin Warner. (Warner's Home State Savings Bank set off a near-disastrous chain reaction when it failed in March.) There's also one foundation among Icahn's partners, The Carl C. Icahn Foundation. Drawing on tax-deductible contributions from Icahn and an Icahn-controlled corporation, the foundation—which, according to its publicly available tax filings, has contributed only minor portions of its assets or income to charity—has invested in at least one of its namesake's limited partnerships, a practice that, depending on regulatory interpretations, might violate Internal Revenue Service regulations limiting such self-dealing.

With these partners in tow, Icahn has now gone after 14 different companies. And he has taken option d)—greenmail or some variation of it, such as selling to a third party whose purchase was arranged by the target company—nine times. He has forced the target into the clutches of a white knight three times. In the two cases where he gained control, he quickly achieved partial liquidations.

So in the reception area at Icahn's Sixth Avenue office, we find 14 neatly framed covers of annual reports—among them those of Marshall Field, Gulf & Western, Dan River Mills, Owens Illinois, and Simplicity Pattern—each trumpeting a quick money triumph.

Icahn could also have another wall full of framed documents: SEC consent decrees he has collected in earlier fights for five of the 14 target companies. And if even a fraction of the additional charges of securities law transgressions made against him in court by his targets before they'd caved were true, he arguably deserved a few more.

If the wall were large enough, he could also include a slew of demerits from his earlier days as a stock trader and arbitrageur: a consent order from the New Jersey Bureau of Securities, a censure from the New York Stock Exchange, a consent agreement with the New York Stock Exchange, an Assurance of Discontinuance from the New York state attorney general's office, and four decisions by the Chicago Board Options Exchange fining Icahn's company for options trading irregularities.

By all accounts, including those of his executive quarry, Icahn is relentlessly singleminded once he starts a fight. In many instances, he unabashedly asks for greenmail. He is always willing to bargain through all hours of the day and night down to the last dollar, frequently seeming to go along with one price, and then prolonging things for hours, claiming he has changed his mind. And he prides himself on negotiating without lawyers, thinking he can best any of his target CEOs one on one (which he probably can). In one deposition, Icahn recalled that when Marshall Field's chairman didn't call him back to agree to a negotiating session, he himself called again because he was "beginning in some way to sort of feel that surge of battle a little bit."

Yet there's something appealing about Icahn—perhaps his obvious, sheer intelligence and confidence in himself as a lone player in an arena where everyone has layers of advisers. There's also his candor. If, as enemies and even friends say, he is one of the greediest men on the planet, he is also in his way delightfully greedy, stripped of all pomposity and pretense. In one suit over his fight for Dan River (which bought him out and went private), Icahn testified, when asked about his prior greenmail payoffs, "I'm not a Robin Hood."

On December 27, 1984, two days after the announcement of the Phillips recapitalization plan and the accompanying buyout of Pickens, Icahn and his web of partnerships and corporations begin buying Phillips stock. The price is about $45.

"I got into it," Icahn will later explain in an interview, "just because I figured something would happen. I thought there really wasn't much risk because the board's offer was too low. They'd have to raise it, or someone would have to come in and better it." Icahn would soon be that someone.

5. THE GROUP

The scene shifts to northern Westchester County and the Bedford, New York, estate of Ivan Boesky, the fabled arbitrageur. It's a Saturday in January. We are about to see that arbitrage in *The Roaring Eighties* may not be as risky as it's cut out to be.

Boesky, like most arbs, has had a horrible Christmas season. Boone Pickens's sellout has threatened to cost Boesky millions; he reportedly bought Phillips stock in the $50s in anticipation of Pickens's deal—or a better one—going through, only to watch the stock drop to the mid-$40s when Pickens was bought out.

Boesky has invited Icahn, who has an estate nearby, to discuss the Phillips fight.

According to Icahn's later deposition,[*] Boesky had called him a few days earlier and said, "I hear you are involved in Phillips." At the time, Icahn's stock purchases were supposedly secret and certainly not a matter of public record; and the information would be gold to Boesky, who presumably could be buying back Phillips stock at its now-lowered price in hopes of evening out his position should a new Phillips suitor appear.

"I think I said, 'Yes, I bought some stock,' but I really don't recall," Icahn testified.

Boesky told me in a February interview that he had "never, ever" spoken to Icahn "about any deals or stocks we're involved in." He otherwise declined all comment about his Phillips trading.

Icahn further testified that during their telephone conversation Boesky said he felt the Phillips situation was ripe for a proxy fight. The two then decided to set up the Saturday meeting.

At this meeting (attended by three other people—an Icahn aide, a Boesky assistant, and a broker from Shearson Lehman/American Express—according to Icahn's testimony), Boesky shies away from joining Icahn in a Phillips fight, but urges him on. Icahn replies that he doesn't like simple proxy fights; rather, he prefers tender offers combined with proxy fights, because while they may be riskier, they put more pressure on the target.

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[*] *This February 19, 1985, deposition, taken by lawyers for Phillips, was sealed by the court. However, after I initiated court proceedings to unseal Icahn's deposition in the 1982 Dan River fight and made it clear that I would pursue a similar course with this deposition, Icahn's lawyers made both available to me.*

Ivan Boesky: Met with Icahn to discuss Phillips, then denied talks took place.

"Did you discuss at what price a tender offer should be made?" Icahn was asked in the subsequent deposition.

"I don't remember going into that. Maybe, but I don't remember it," he replied.

"Did you discuss how much money would be needed for a successful tender offer for Phillips?" he was asked.

"All of this must have come up," he answered. "I remember generally we talked about all of these things, but I don't remember any more.

"Then later on, Ivan [Boesky] kept calling me,." Icahn added.

According to Icahn's deposition, "a few other" arbitrageurs were in contact with him, either before he announced a bid for Phillips or soon thereafter. But the clannishness doesn't stop there. When asked in the deposition about whether the subject of financing a Phillips tender offer came up in his chat with Boesky, Icahn replied, "The name Drexel came up."

Drexel, of course, is Drexel Burnham Lambert Incorporated, America's preeminent junk-bond dealer. (More on that later.) And, according to one Drexel banker and to other deposition testimony, it was Boesky who brought up Drexel's name to Icahn. Indeed, Drexel, according to other deposition testimony, had thought up a leveraged junk-bond scheme for a Phillips tender offer and "was looking for someone to do it," says the Drexel banker.

Arbitrage may not be as risky as it's cut out to be. According to Icahn, he and Boesky talked about a proxy fight and tender offer for Phillips well before February 4, when Icahn made his bid.

Takeover entrepreneur Carl Icahn: "I'm not a Robin Hood."

"One guy we started with was Ivan, because we knew he'd been burned by Pickens and figured he might try to sell it to someone else even if he didn't take it himself, which is just what happened with Icahn."

"Yes, we talked to Boesky before we talked to Icahn about a financial package for a Phillips takeover," confirms David Kay, head of mergers and acquisitions at Drexel. "It was our package, and we were trying to interest someone in it. . . . I probably talk to Ivan everyday," he says.

In short, Boesky, an arbitrageur with a need for inside information (Is there any other word for secret information about a possible tender offer?) was out discussing, perhaps even encouraging, an Icahn tender offer formulated by Drexel. And Drexel, of course, could have been passing that same information on to any of its other stock speculator clients, too—not in the traditional and black-letter sense of tipping someone off with inside information, but in the context of asking people to consider the deal for themselves, while mentioning that Icahn was seriously considering it.

"These arbitrageurs and takeover entrepreneurs and people from Drexel are a ring, pure and simple," asserts one takeover adviser. "They feed on their own inside information and cooperation, and to believe anything to the contrary is to be ridiculously naive."

According to Icahn's deposition testimony, Boesky sold him 2.74 million shares of Phillips on January 28. But, his testimony continues, 11 days later, on February 9—five days after Icahn announced his bid for Phillips—he and Boesky met again, this time over dinner at Icahn's house. At that meeting they discussed the fact that Boesky had bought another 4 million Phillips shares.

Had Boesky bought the shares before Icahn's bid, but after their January discussions when he had learned that Icahn was contemplating a bid, thereby taking advantage of that information? Had Boesky done any trading *at all* in Phillips stock during the time he was discussing with Icahn and Drexel the plan for a tender offer? Asked these specific questions, Boesky again declined all comment on his trading activities, citing longstanding "Boesky company policy," except to say, "I seem to detect an insinuation that such trading would in some way be wrong . . . or improper, which I find kind of unattractive . . . and offensive coming from a responsible publication." Was Icahn's deposition about their discussions accurate? "I really don't think I should comment on that," Boesky replied, "except to say that I wonder whether it is proper or legal for you to publish something like [the deposition], and that it would be foolish and not nice of me to sit here and take potshots at what a friend of mine has said under oath, whether it's true or not."

According to Icahn's testimony, after that February 9 meeting at Icahn's house, Boesky "was on the phone with me every day." The arbitrageur, of course, had a big stake in knowing what Icahn was doing and how he was faring.

It is about this time, according to Icahn's deposition, that Icahn gets those mysterious late-night phone calls cheering him on in the Phillips fight. Is it an arbitrageur? Is it someone from Drexel Burnham? Is it someone else?

6. ICAHN'S MAGIC OFFER

It is now February 4, 1985. A messenger delivers a letter from Icahn to Douce, via Morgan Stanley. Icahn begins by telling Douce that he owns 7.5 million shares of Phillips—or about 5 percent, purchased for about $350 million—"which makes me one of the company's largest shareholders.

"I have examined the material you have sent me concerning [the recapitalization plan] and find it grossly inadequate," Icahn's letter continues. Icahn then proposes that he acquire all of Phillips for what he calls $55 per share—$27.50 in cash and $27.50 in a subordinated note. Icahn goes on to say that the financing will be provided by Drexel Burnham Lambert Inc., which is, he says, "highly confident" it can raise the money. Icahn also threatens an alternative: If Douce and his board don't withdraw their recapitalization plan in favor of his offer, he intends to begin a proxy fight to defeat the recapitalization, scheduled to be voted on at a shareholders' meeting in Bartlesville on February 22, and to begin a tender offer for 51 percent of the shares at $55 in cash and what he says will be $55 in debt securities for the remaining 49 percent.

At face value, a $55 bid for the Phillips shares is an $8.1-billion offer for the company. And face value is exactly how the press plays it: Icahn's offer is called a $55 offer.

An attached letter from Drexel Burnham corporate managing director Leon Black repeats the "highly confident" claim and reveals that the financing to be arranged amounts to $4.05 billion, which will cover all of the cash portion of the offer to the shareholders. When all the numbers are added up, this means that if Icahn's plan goes through the company will have just $800 million in stock and about $11 billion in debt. Even considering Icahn's stated plan to sell $3.7 billion in unspecified Phillips assets, this debt-to-equity ratio seems to leave the company hopelessly mired in interest payments, with nothing to invest in research or oil exploration and in grave trouble if cash flow should slow.

After going through the motions of asking Icahn to answer written questions about the offer, Douce and the Phillips board reject it. They also sue Icahn, claiming among other things that his letter to Douce, which he knew the company would have to make public, constituted the sending of proxy material without prior SEC clearance, and that it was false and fraudulent proxy material because of its supposedly unfounded criticism of the board's recapitalization plan.

A few days later, Phillips puts the lie to the bona fides of its first recapitalization offer by sweetening it so that the shareholders get a package the company says is worth $3 more. (The market soon pegs its value at about a dollar more.) More important, the company announces that its board has passed a poison pill.

The dreaded poison pill. It is a Lipton creation of almost diabolical repute. In its various incarnations, it gives shareholders a right to demand all kinds of extra money in the form of debentures, or rights to sell their stock to an acquiring company, or rights to buy an acquiring company's stock if an acquirer buys more than 20 percent (or, in some cases, 30 percent) of a company. Its stated purpose is to prevent partial two-tier takeover bids by allowing the remaining shareholders to make life miserably expensive for the acquirer, a problem eliminated in most of the pills if the acquirer buys out all the shareholders, because then the acquirer owns whatever misery-causing rights that shareholder had been given.

In this incarnation, Lipton's pill allows shareholders to redeem their shares for $62 in debentures the moment anyone buys more than 30 percent of the company. In other words, Icahn would be buying into a company where everyone—except him, because the 30 percent buyer somehow is discriminated against and doesn't get these rights—would have a $62 debt package. Depending on your point of view (or your stock position), Lipton's pill is an ingenious way to make sure the shareholders get what the company is worth, and aren't stampeded into selling out cheap; or it's an outrageous usurpation by management of the shareholders' rights to decide on Icahn's offer for themselves, with management having set an unrealistically high price—$62—and having cleverly come up with a way (this pill) to make all the shareholders stick to it, just so management can't be thrown out in a takeover.

This pill is adopted less than three weeks after a Delaware court has decided that a similarly intended, though differently configured, Lipton pill aimed at saving Household International from a possible raid is perfectly legal.

The camera now shifts to any February morning at the Regency Hotel in New York, where Joe Flom or others from Skadden, Arps can be found arguing, persuasively, that Lipton's pill is a patently illegal usurpation of shareholder rights, and that unless the Delaware appellate court (where Skadden will be arguing against the Household pill) overturns the lower court decision, the takeover game may be frozen by this Rube Goldberg monstrosity.

Indeed, at almost every table at the Regency, lawyers, investment bankers, CEOs, and their clients are talking about the pill; and most seem awed by its ominous impact.

"Marty comes up with a new trick, and it's like someone passed legislation," comments takeover expert Arthur Fleischer, Jr., of Fried, Frank, Harris, Shriver & Jacobson one morning over an omelet. "Don't they realize it's a passing fad that has ten antidotes?"

Fleischer doesn't realize how right he is, and how soon we'll all find out that in *The Roaring Eighties* fads like the pill pass quickly indeed.

Underlying the pill and other Phillips defenses is the company's attack on Icahn's offer as unreal because the financing has not been lined up and Icahn won't be able to get it.

7. THE JUNKMEN SELLETH

How can a man who's prepared to spend only $350 million in cash (the cost of his original stock purchases) bid more than $8 billion for a company? Enter Drexel Burnham, the investment banking house where in *The Roaring Eighties* people seem to be having the best time of all. Drexel has led the way in promoting the current darling of *The Roaring Eighties*, the high-risk, high-yield, "junk" bond. The firm's clients include what one top lawyer calls "a murderers' row of takeover raiders"—Saul Steinberg, Carl Lindner, Victor Posner, the Bass brothers, the Canadian Belzberg family, Irwin Jacobs, Sir James Goldsmith, Pickens, Icahn. When a raider is stalking prey, he forms a dummy corporation or partnership, for which Drexel sells these high-yield bonds, which will ultimately be secured by the assets of the company to be taken over. In other words, it's a mechanism for a hostile leveraged buyout: The raiders buy the company with the company's anticipated cash flow.

If the takeover doesn't go forward, the subscribers to the bond still get a commitment fee (paid by the raider) for having pledged their money. In the Icahn-Phillips deal these fees were three-eighths of one percent, or $37,500 for each $10 million pledged.

Drexel's take in these deals is high, even by investment bankers' porcine standards. In the Icahn-Phillips deal, Drexel's retainer letter calls for the firm to be paid $1 million the moment Icahn uses its feared name in any public statement, then 2 percent of all the financing it arranges—or more than $80 million—if the deal goes through. Moreover, if the deal does not go through, Drexel is to get as much as 20 percent of the incremental profit Icahn makes from selling his stock to anyone else, plus one-eighth of one percent in its own commitment fees for the money it has lined up, which would be as much as $5 million.

Drexel's Leon Black: "Highly confident" of raising $4.05 billion for Icahn.

The question of whether Drexel can in fact peddle $4.05 billion in junk bonds for Icahn's deal, let alone whether Icahn really wants to raise the money and take over the company or is just bluffing to force a higher bid from the company or from someone else, is high drama—and the subject of Phillips's newspaper ads attacking the Icahn offer under the headline "Is Icahn For Real?"

The issue is sharpened on February 15. With just a week to go before the vote on management's recapitalization plan, which Icahn has declared the shareholders must reject in order to take his plan, Icahn announces that in just 48 hours Drexel has lined up $1.5 billion. Where have these commitments come from? The very people who have done other Drexel junk-bond raids (such as Steinberg and Lindner), a host of arbitrageurs (though not Boesky) with an obvious interest in seeing Icahn's deal or some new deal go through, plus the kind of high-flying insurance companies or savings and loan institutions that have been Drexel's base in selling these junk bonds.

To explain why these people signed on for junk bonds in a company that was going to be neck-high, or higher, in debt, our camera takes us to Drexel's Beverly Hills sales floor (its West Coast office is the center of junk-bond financings), where eager young bankers under the tutelage of junk-bond impresario Michael Milken, 38, are pushing $1.5 billion worth of bonds in units as small as $3 million.

We then cut to their various customers across the country. Several tell us they're in it because they believe in Icahn's stated plan to liquidate $3.7 billion in assets to slash some debt and to pay down the remaining debt through better management of the remaining assets. They like the yield on their junk bonds—it ranges as high as 16 percent a year, depending on the seniority of the debt—and they're confident Icahn can run the company in a way that will see the debt paid. Can they really believe that Carl Icahn—whose management experience consists of running a staff of 30 and supervising two partially liquidated midsized companies he's taken over in recent years—is going to run a corporation larger than Xerox, Boeing, Westinghouse, or ABC? Can they really believe he's going to get into Bartlesville (where he has promised to keep the company headquarters but where prayer vigils and other demonstrations have been organized against him by fearful, resentful townspeople), let alone know what to do when he gets there?

Others aren't as sure as that about how Icahn will fare, but they feel good about Drexel's assurances, all oral, that there will be a good secondary market in the bonds, or perhaps a fast payoff because Icahn just might liquidate the whole company if he gets control. Still others want to support Icahn's bid because they like the commitment fee and have shares in Phillips that will rise if the recapitalization plan is defeated; and, they're being told by Drexel, a show of support for Icahn will help defeat the plan. At least one whom I interviewed seems to be in it just for the easy commitment fee; he claims he's received tacit assurances from Drexel that the deal is not likely to go through, and therefore he's not likely to have to put the money up. (A Drexel spokeman declines all comment "on our solicitation activities, although you can assume we conduct ourselves in a responsible manner.") Finally, there are Icahn's compatriots—such as Steinberg, who according to a deposition had bought Phillips stock; they apparently have signed on for some variety of the above reasons, along with a desire to help someone who will help them with their next deal.

Drexel's Michael Milken: The impresario of junk-bond financing.

How can Drexel's people be on the phone offering these securities with no written material? We cut to the SEC, where everyone is sleeping. "These are sophisticated investors," a source in the enforcement division at the SEC says, when roused by our question. "They know what they're doing."

"It's all just a ring, with Drexel at the center," says one lawyer. "Today they go in for a bluff for Phillips, with Icahn as the front guy. . . . And next month it'll be Lindner."

We cut to lines of customers waiting for Ohio savings and loans to open in the wake of the chain reaction that savaged their confidence in the banks after Home State Savings Bank—controlled by Icahn's sometime partner Marvin Warner—was so *un*sophisticated that it went under investing in the E.S.M. treasury securities Ponzi scheme that erupted in March. Then we cut to crowds outside the Financial Corporation of America's savings and loan branches in California; until it almost went under, Financial Corporation was controlled by Charles Knapp, who is now committing $100 million, through a second entity he controls, to Drexel's Phillips-Icahn junk bonds. The point is perhaps a bit indirect, but it is real. There are more than a dozen savings and loans, insurance companies, and other financial institutions on whose health millions of Americans depend signed up for Drexel's Phillips-Icahn junk bonds. How sophisticated are the people who run them about gauging risk? Are they so high on the everything-works euphoria of *The Roaring Eighties* that risk evaluation has for them become a sissy's game?

Watching it all, a cynic in the audience might even conclude that, as one lawyer puts it, "it's all just a ring that lines up bluff money, with Drexel at the center. Today they go in for a bluff for Phillips, with Icahn as the front guy. Last year it was Disney with Steinberg"—indeed, many of the same investors drew the same type of commitment fees in Steinberg's Disney greenmail deal—"and next month it'll be Lindner. And then it'll be Charlie Knapp," he adds.

But why hasn't Icahn gotten the full $4.05 billion? Because, he says, he doesn't want to pay the additional commitment fees until he knows that management's recapitalization plan has been defeated. As it is, he has already paid $7.5 million in commitment fees—three-eighths of one percent to the junk subscribers, plus one-eighth of one percent to Drexel. His proxy solicitors are now urging him to up the ante and show more strength; so is Boesky, who is "calling every day," Icahn later testified. But Icahn sticks at $1.5 billion. Is he bluffing? Is Drexel bluffing?

While we're on the subject of bluffing, the camera shifts to the SEC, where once again we find everyone asleep. How else can one explain why this fiasco is being allowed to continue, with Icahn calling this whatever-it-is of his a tender offer? That in itself seems like fraud worthy of an immediate SEC move to enjoin Icahn from proceeding. This isn't a tender offer; it's a request for a gratuitous option. For Icahn has conditioned his offer on obtaining financing, yet he has not obtained the financing, nor is he out there trying to get it, or even promising to try to get it. He's basically saying, "Let me hold your stock for a while and use it to get credibility, while I decide whether to gather financing and go ahead with this."

Wachtell, Lipton has sent letters to the SEC arguing this point, but to no avail. "We figured the people involved in this deal are sophisticated people and can make that decision," our SEC source later explains, ignoring the clear case law that says that a tender offer, to be called such, must be a contractual offer that is binding on the party making the tender offer to buy the shares if the shareholder tenders them, subject only to conditions that are not within the offerer's control.

8. DEFENDING THE ADVERSARY SYSTEM

In these and other legal battles, Icahn is defended not only by his lawyers at New York's 41-lawyer Gordon Hurwitz Butowsky Weitzen Shalov & Wein (plus Oklahoma and Delaware counsel), but also by 280-lawyer Paul, Weiss, Rifkind, Wharton & Garrison. "You go after a company and Marty Lipton starts throwing all kinds of chairs at you, which offends me," says Gordon Hurwitz partner Marc Weitzen, referring to Wachtell, Lipton's host of efforts at injunctions, as well as the poison pill gambit. "It also makes the litigation heavier than a firm our size can sustain," Weitzen adds.

"Once it was clear that the thing started to get messy and we'd need a lot of litigators, I knew we needed a large firm," explains Icahn. "Paul, Weiss had already been retained by Drexel Burnham, so since they were up to speed I figured I'd use them instead of Weil, Gotshal [& Manges], whom I usually use when I need a big firm. And they were very eager to do it for me, so it worked out fine."

In motions seeking temporary restraining orders against Icahn, Wachtell, Lipton and local counsel Crowe & Dunlevy of Oklahoma City and Boone, Smith, Davis & Hurst of Tulsa attack him as a "fast-buck" takeover entrepreneur and greenmailer. Paul, Weiss answers that Icahn's plan represents the best interests of all shareholders, that all the things Phillips is doing to stop him are tricks intended to "rig the forthcoming vote [on the recapitalization plan] with false, misleading, and deliberately confusing proxy material," and that Phillips's "ad hominem attacks [on Icahn] are still another effort to disrupt the proxy process." The camera pans in on the Paul, Weiss letterhead affixed to these arguments.

Then the camera flashes back three years, to another Paul, Weiss brief in another Icahn takeover fight, this one involving Dan River, Inc. But the picture is confusing. For in this brief the firm is accusing Carl Icahn of racketeering and market manipulation, and comparing his announcing his intention to purchase Dan River stock to his buying an "ad in a Danville newspaper . . . stating that he is about to enter Dan River's mill and break the windows . . . unless he is paid $1,000." The brief goes on to argue that Icahn's "entire pattern of buying into companies and threatening a liquidation or a fight for control unless the company pays defendants a premium for their stock (or obtains a white knight to do so), is extortionate or manipulative, and thus constitutes a pattern of predicate RICO acts, from which profits were derived that now are being invested in Dan River. In short, defendants are using tainted money to 'infiltrate' Dan River and should be enjoined from further so doing."

Another flashback shows Paul, Weiss partner Max Gitter tearing into Icahn at a Dan River deposition and, as four different sources remember it, being nearly obsessed with what in his view was the dire threat to lawful business affairs that Icahn represented. As one of the four puts it, "Max was emotionally involved in this case and in what a bad guy Icahn was. I swear to you he was foaming at the mouth at one point, ranting and raving about Carl."

Gitter declines comment on his work against Icahn, except to say that he acted as an advocate for client Dan River "ethically and in ways consistent with the Code of Professional Responsibility's requirements" that a lawyer not make frivolous claims, and that he was not "emotionally involved."

Gitter is not involved in his firm's current efforts on Icahn's behalf, but two other Paul, Weiss partners active in the Dan River defense against Icahn are now working for Icahn on the Phillips deal. The camera now comes back to them. The first, Moses Silverman, tells us that "other than to acknowledge that I went both ways, I don't want to comment." The second, Arthur Liman, says that these kinds of shifts are "routine aspects of the adversary system." Asked how the firm can argue for the bona fides of Icahn's investment today when in the past it took the position that the money he had amassed was gathered by extortion and, therefore, tainted and forfeitable under the racketeering statute. Liman replies, "Our willingness to argue on behalf of any client is what strengthens the adversary system. We do it because it contributes to the system."

Asked if he minds having lawyers on his payroll who have called him an extortion artist and racketeer, Icahn shrugs and says, "Frankly, I wasn't aware of any of those charges. Who cares? Lawyers'll say whatever they're paid to say. You can't let it bother you. It's all part of this game."

9. THE MONEY MEN

It is February 21, a day before the vote is scheduled on the recapitalization plan. The rules are that Phillips must get a majority to vote *for* its plan; a non-vote, therefore, will effectively count for Icahn's side.

Remember, Icahn is not only soliciting proxy votes from shareholders against the plan, he also has a tender offer pending, which he has now changed to $60 in cash, financed by those junk-bond buyers, for about 45 percent of the shares, and what he says amounts to $50 in notes (which will be lower than even the junk bonds in payment priority) for the rest of the shares. But his tender offer is conditioned on the recapitalization plan being defeated. As for Lipton's poison pill, Icahn has come up with a relatively simple antidote: When soliciting for the tender offer, he's also soliciting for the shareholders' consent to remove the board of directors and replace it with his own board without holding a shareholders' meeting. In other words, if he gathers a majority of the consents, he can have a meeting with himself and install his own board. And, he promises, his new board will immediately abolish the poison pill, enabling his tender offer to go forward.

With Phillips saying its recapitalization offer is worth $53 and Icahn saying it's worth $42, and Icahn saying his offer is worth $55 and Phillips saying it isn't worth anything close to that, and with outside people saying both sides are stretching the truth, where's the SEC?

While we're at it, why hasn't the SEC come down on Phillips for claiming that Icahn intends to "bust up" Phillips and move the corporate headquarters, when for the record he has promised not to move out of Bartlesville, and said he'll sell $3.6 billion in assets as compared to the Phillips plan to sell $2 billion? And why hasn't the SEC made Drexel Burnham file as part of Icahn's group? Drexel, after all, will share heavily in Icahn's profits if he resells the stock. Drexel is responsible for formulating the plan in the first place, and is wholly responsible for financing it. Drexel is wholly responsible for gathering the group who will buy not only all the junk bonds, but also most of the small amount of stock there will be in the company, and who already own enough of the stock to constitute a group for SEC filing purposes. Besides, Drexel, like Icahn, has two representatives on the slate of directors Icahn proposed in his proxy fight.

We cut back to SEC headquarters. The lights are out.

Now we cut to the electorate who, unaided by any apparent SEC policing, will decide the Icahn-Phillips fight. We learn that by now, with all the arb activity, some 60 percent of Phillips shares are controlled by institutions. (The latest studies indicate that institutions now have about 50 percent of all the voting power of shares traded on the New York Stock Exchange.)

Martin Lipton: No more "bust-up junk-bond takeovers" for Wachtell, Lipton.

Who are these "institutions"? Some are the arbs, who have probably accumulated, or been stuck with, about 5 percent that they are ready to vote unquestionably for Icahn. The rest, says one exasperated Phillips lawyer, are "a bunch of brainless thirty-year-old kids who will do anything for the quick buck because their goddamn jobs depend on beating the Standard and Poors every month or every week or every hour."

Actually, some are in their forties and fifties. Other than that, the assessment isn't far off. In random interviews of a dozen institutional money managers who own Phillips stock, I find by and large a surprisingly uninformed and just plain dumb group of voters. Most don't understand the basics of Icahn's offer or Phillips's recapitalization plan, let alone the poison pill or the consent process that would overturn it. But the real point is that they don't care. They just want the company "kept in play," as the phrase goes, meaning they want all options kept open. So they're voting against the recapitalization plan.

In fact, they're voting against the plan on the proxy cards that Phillips is sending out asking for a vote *for* the management plan, rather than waiting for Icahn's cards to arrive. (An injunction had briefly delayed his solicitation.)

The Phillips lawyers and bankers had figured they had the vote locked up, for with the poison pill in place the shareholders had only one alternative—the recapitalization plan. If they voted it down, the pill would seemingly protect Phillips from other offers, and the stock would sink back into the $30s.

Yet as the Phillips people are counting their own proxy cards and seeing all the surprising negative votes—it's unprecedented for one side to have so many of its own cards cast against it—they begin to see that they have misread the electorate. Sure, some public pension funds had announced that they had banded together as a kind of new shareholder rights group and vowed to fight poison pills, implying they'd vote against the recap plan.

"What I cared about," says one pension fund manager, "was that I have a meeting twice a month with my boss, and he goes over my portfolio. I needed to keep [Phillips] in play to get money out of it."

Will the stock market crash? History may not repeat itself, argues the author of The Great Crash, *but the dynamics of speculation are remorselessly constant, and they, along with other ominous indicators, give no comfort to optimism*

THE 1929 PARALLEL

BY JOHN KENNETH GALBRAITH

Senator Couzens:	Did Goldman, Sachs and Company organize the Goldman Sachs Trading Corporation?
Mr. Sachs:	Yes, sir.
Senator Couzens:	And it sold its stock to the public?
Mr. Sachs:	A portion of it. The firms invested originally in ten per cent of the entire issue for the sum of ten million dollars.
Senator Couzens:	And the other ninety per cent was sold to the public?
Mr. Sachs:	Yes, sir.
Senator Couzens:	At what price?
Mr. Sachs:	At a hundred and four. That is the old stock . . . the stock was split two for one.
Senator Couzens:	And what is the price of the stock now?
Mr. Sachs:	Approximately one and three quarters.

—from the Senate Hearings on Stock Exchange Practices, 1932

IN MARCH OF 1929 PAUL M. WARBURG, A FOUNDING PARent of the Federal Reserve System and an immensely prestigious banker in his time, called attention to the current orgy, as he said, of "unrestrained speculation" in the stock market and added that were it not brought to an end, there would be a disastrous collapse. His warning was badly received. It was made clear that he did not appreciate the new era in economic well-being that the market was so admirably reflecting; he was said by one exceptionally articulate critic to be "sandbagging American prosperity." Less eloquent commentators voiced the thought that he was probably short in the market.

There was a decidedly more sympathetic response somewhat later that year to the still remembered observation of Professor Irving Fisher, of Yale, one of the most diversely innovative scholars of his time. Fisher said, "Stock prices have reached what looks like a permanently high plateau." Fisher was, in fact, long in the market and by some estimates lost between eight and ten million dollars in the almost immediately ensuing crash.

There is here a lesson about the larger constant as regards financial aberration and its consequences. There is a compelling vested interest in euphoria, even, or perhaps especially, when it verges, as in 1929, on insanity. Anyone who speaks or writes on current tendencies in financial markets should feel duly warned. There are, however, some controlling rules in these matters, which are ignored at no slight cost. Among those suffering most will be those who regard all current warnings with the greatest contempt.

The first rule—and our first parallel with 1929—has to do with the stock market itself and, as it may somewhat formally be called, the dynamics of speculation.

Any long-continued increase in stock prices, such as preceded the 1929 crash and such as we experienced at least until last September, brings a change in the purposes of the participants in the market. Initially the motivating force is from institutions and individuals who buy securities (and bid up prices) because of some underlying circumstance, actual or imagined, that is judged to affect values: The economy as a whole is improving. Inflation as a threat is pending or perhaps receding. The tax prospect seems favorable. Or, mercifully, a business-oriented Administration has come to power in Washington. Most of all, in a time when common-stock dividends are largely a fixed dole to stockholders, interest rates are thought likely to decline. This calls for a compensating increase in the value of stocks if they are to earn only the new going return. On such matters virtually all comment concerning the market, informed and often otherwise, centers.

But as a stock-market boom continues (the same can be true as regards a boom in real estate or even art), there is increasing participation by institutions and people who are attracted by the thought that they can take an upward ride with the prices and get out before the eventual fall. This

ILLUSTRATION BY DAVID SUTER

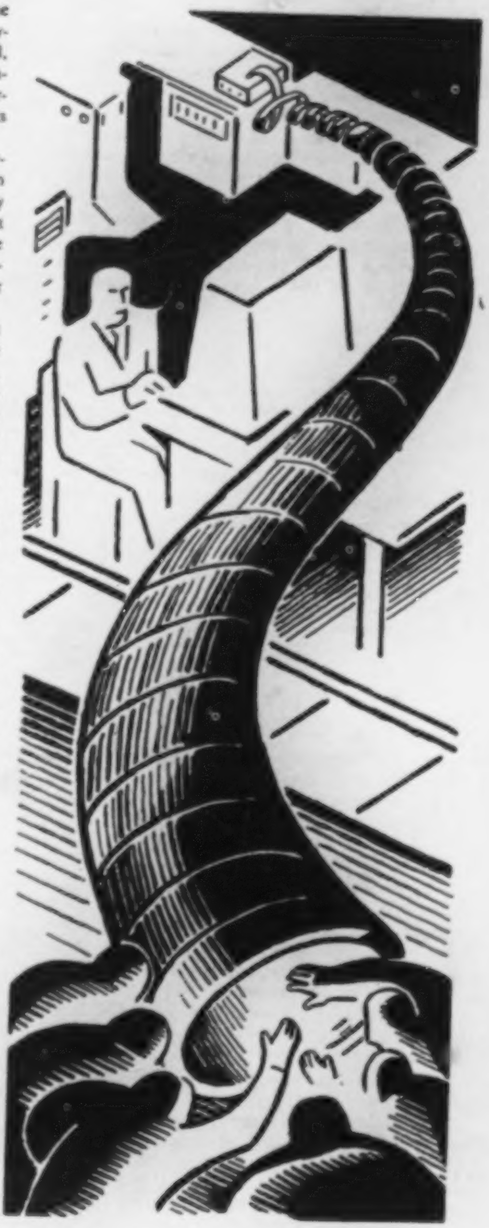
participation, needless to say, drives up prices. And the prices so achieved no longer have any relation to underlying circumstance. Justifying causes for the increases will, also needless to say, be cited by the sadly vulnerable financial analysts and commentators and, alas, the often vulnerable business press. This will persuade yet other innocents to come in for the loss that awaits all so persuaded.

For the loss will come. The market at this stage is inherently unstable. At some point something—no one can ever know when or quite what—will trigger a decision by some to get out. The initial fall will persuade others that the time has come, and then yet others, and then the greater fall will come. Once the purely speculative component has been built into the structure, the eventual result is, to repeat, inevitable.

There will previously have been moments of unease from which there was recovery. These are symptoms of the eventual collapse. In 1928 and through the winter, spring, and summer of 1929 the stock market divorced itself from all underlying reality in the manner just cited. Justification was, of course, asserted: the unique and enduring quality of Coolidge and Hoover prosperity; the infinitely benign effects of the supply-side tax reductions of Secretary of the Treasury Andrew W. Mellon, who was held to be the greatest in that office since Alexander Hamilton; the high-tech future of RCA, the speculative favorite of the time, which so far had not paid a dividend.

But mostly speculators, amateur and otherwise, were getting on for the ride. In the spring of 1929 came the initial indication of instability—a very sharp break in the market. Prices recovered, and in the summer months they rocketed up. There was another bad break in September and further uneasy movements. Then, at the end of October, came the compelling rush to get out and therewith the crash. No one knows what precipitated it. No one ever will. A few—Bernard Baruch and, it has long been said, Joseph P. Kennedy—got out first. Most went down with the mob; to an extraordinary degree, this is a game in which there are mainly losers.

The question now, in the winter of 1987, is whether the stock market is or has been repeating its history. There was, early last year, a period of very sharply appreciating prices following an earlier, slower ascent. Then, on September 11 and the days following, came a severe slump, the worst in any recent period. So far (as this is written) there has been no significant recovery. As to the further prospect, no one knows, despite the extreme willingness to say otherwise on the part of many who do not know. What is certain, however, is that once again there existed a speculative dynamic—of people and institutions drawn by the market rise to the thought that it would go up more, that they could ride the rise and get out in time. Perhaps last September signaled the end; perhaps it was an episode in a continuing speculative rise with a worse drop yet to come. What we do know is that speculative episodes never come gently to an end. The wise, though for most the improbable, course is to assume the worst.



Another stock-market collapse would, however—one judges—be less traumatic in its larger effect than was the one in October of 1929. The Great Crash had a shattering effect on investment and consumer spending and eventually on production and employment, leading to the collapse of banks and business firms. Now there are safety nets, as they are called. Unemployment compensation, pensions, farm-income support, and much else would have a general cushioning effect, along with government fiscal support to the economy. There is insurance of bank deposits and the further certainty that any large corporation, if in danger, would be bailed out. Modern socialism, as I've elsewhere said, is when the corporate jets come down on National and Dulles airports.

A SECOND, RATHER STRONGER PARALLEL WITH 1929 IS the present commitment to seemingly imaginative, currently lucrative, and eventually disastrous innovation in financial structures. Here the similarity is striking and involves the same elements as before. In the months and years prior to the 1929 crash there was a wondrous proliferation of holding companies and investment trusts. The common feature of both the holding companies and the trusts was that they conducted no practical operations; they existed to hold stock in other companies, and these companies frequently existed to hold stock in yet other companies. Pyramiding, it was called. The investment trust and the utility pyramid were the greatly admired marvels of the time. Samuel Insull brought together the utility companies of the Midwest in one vast holding-company complex, which he did not understand. Similarly, the Van Sweringen brothers built their vast railroad pyramid. But equally admired were the investment trusts, the formations of Goldman, Sachs and Company and the United Founders Corporation, and—an exceptionally glowing example of the entrepreneurial spirit—those of Harrison Williams, who assembled a combined holding-company and investment trust system that was thought to have a market value by the summer of 1929 of around a billion dollars. There were scores of others.

The pyramids of Insull and the Van Sweringens were a half dozen or more companies deep. The stock of the operating utility or railroad was held by a holding company. This company then sold bonds and preferred stock and common stock to the public, retaining for itself enough of the common stock for control. The exercise was then repeated—a new company, more bonds and stock to the public, control still retained in a majority or minority holding of the stock of the new creation. And so forth up the line, until an insignificant investment in the common stock of the final company controlled the whole structure.

The investment trusts were similar, except that their ultimate function was not to operate a railroad or a utility but only to hold securities. In December of 1928 Goldman, Sachs and Company created the Goldman Sachs Trading Corporation. It sold securities to the public but retained enough common stock for control. The following July the trading corporation, in association with Harrison Williams, launched the Shenandoah Corporation. Securities were similarly sold to the public; a controlling interest remained with the trading corporation. Then Shenandoah, in the last days of the boom, created the Blue Ridge Corporation. Again preferred stock and common were sold to the public; the controlling wedge of common stock remained now with Shenandoah. Shenandoah, as before, was controlled by the trading corporation, and the trading corporation by Goldman Sachs. The stated purpose of these superior machinations was to bring the financial genius of the time to bear on investment in common stocks and to share the ensuing rewards with the public.

No institutions ever excited more admiration. The creators of the investment trusts were men of conceded as well as self-admitted genius, and were believed to have a strong instinct for the public interest. John J. Raskob, the chairman of the Democratic National Committee in those days, thought an investment trust might be created in which the toiling masses would invest from their weekly earnings. He outlined the proposal in a *Ladies' Home Journal* article titled "Everybody Ought to Be Rich."

In all these operations debt was incurred to purchase common stock that, in turn, provided full voting control. The debt was passive as to control, so was the preferred stock, which conferred no voting rights. The minority interests in the common stock sold to the public had no effect of power either. The remaining, retained investment in common stock exercised full authority over the whole structure. This was leverage. A marvelous thing. Leverage also meant that any increase in the earnings of the ultimate companies would flow back with geometric force to the originating company. That was because along the way the debt and preferred stock in the intermediate companies held by the public extracted only their fixed contractual share; any *increase* in revenue and value flowed through to the ultimate and controlling investment in common stock.

It was a grave problem, however, that in the event of failing earnings and values, leverage would work fully as powerfully in reverse. All income and value, and in practice more, would be absorbed by the outer debt and preferred shares; for the originating company there would remain literally—very literally—nothing. But of this in 1929 no one, or not many, thought; a rising market combined with the managerial and investment genius of the men who built these structures made any such concern seem irrelevant in the extreme.

Here the parallel: after fifty-seven years investment trusts, called closed-end funds, are now coming back into fashion, although still, I would judge, in a rather modest way as compared with 1929. The more exciting parallel is in the rediscovery of leverage. Leverage is again working its wonders. Not in utility pyramids: these in their full 1929 manifestation are forbidden by law. And the great investment houses, to be sure, still raise capital for new and expanding enterprises. But that is not where the present interest and excitement lie. These lie in the wave of corporate takeovers, mergers, and acquisitions and the *leveraged* buy-outs. And in the bank loans and bond issues, not excluding the junk bonds, that are arranged to finance these operations.

The common feature of all these activities is the creation of debt. In 1985 alone some $139 billion dollars' worth of mergers and acquisitions was financed, much of it with new borrowing. More, it would appear, was so financed last year. Some $100 billion in admittedly perilous junk bonds (rarely has a name been more of a warning) was issued to more than adequately trusting investors. This debt has a first claim on earnings; in its intractable way, it will absorb all earnings (and claim more) at some astringent time in the future.

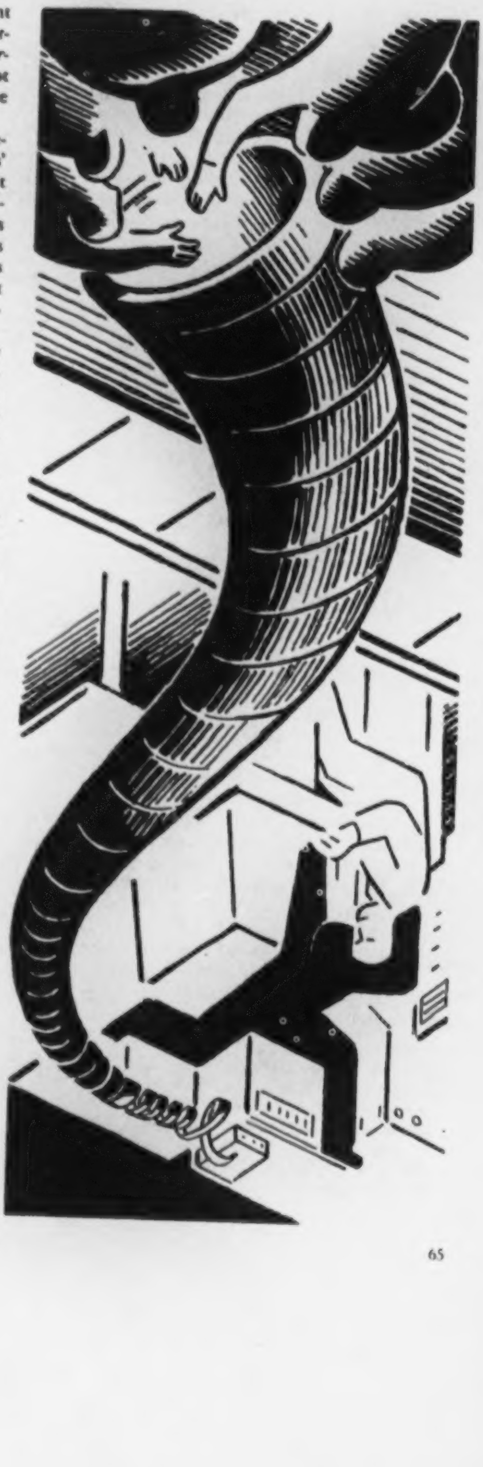
That time will come. Greatly admired for the energy and ingenuity it now and recently has displayed, this development (the mergers and their resulting debt), to be adequately but not unduly blunt, will eventually be regarded as no less insane than the utility and railroad pyramiding and the investment-trust explosion of the 1920s.

Ever since the Compagnie d'Occident of John Law (which was formed to search for the highly exiguous gold deposits of Louisiana); since the wonderful exfoliation of enterprises of the South Sea Bubble; since the outbreak of investment enthusiasm in Britain in the 1820s (a company "to drain the Red Sea with a view to recovering the treasure abandoned by the Egyptians after the crossing of the Jews"); and on down to the 1929 investment trusts, the offshore funds and Bernard Cornfeld, and yet on to Penn Square and the Latin American loans—nothing has been more remarkable than the susceptibility of the investing public to financial illusion and the like-mindedness of the most reputable of bankers, investment bankers, brokers, and free-lance financial geniuses. Nor is the reason far to seek. Nothing so gives the illusion of intelligence as personal association with large sums of money.

It is, alas, an illusion. The mergers, acquisitions, takeovers, leveraged buy-outs, their presumed contribution to economic success and market values, and the burden of debt that they incur are the current form of that illusion. They will one day—again, no one can say when—be so recognized. A fall in earnings will render the debt burden insupportable. A minor literature will marvel at the earlier retreat from reality, as is now the case with the Penn Square fiasco and the loans to Latin America.

THE THIRD PARALLEL BETWEEN PRESENT AND PAST, which will be vividly and also painfully revealed, concerns one of the great constants of capitalism. That is its tendency to single out for the most ostentatious punishment those on whom it once seemed to lavish its greatest gifts.

In the years before the 1929 crash the system accorded fortune and prestige to a greatly featured group of men—



to Arthur W. Cutten, M. J. Meehan, Bernard E. ("Sell'em Ben") Smith, and Harry F. Sinclair, all market operators of major distinction; also to Charles E. Mitchell, the head of the National City Bank as it then was, and Albert Wiggin, the head of the Chase National Bank, both deeply involved in the market on their own behalf; to Ivar Kreuger, the Match King, international financier (and sometime forger of government bonds); and to Richard Whitney, soon to become president of the New York Stock Exchange and its most uncompromising public defender.

All suffered a fearful fall after the crash. Called before a congressional committee, Cutten, Meehan, and Sinclair all had grave lapses of memory. Mitchell and Wiggin, the great bankers, were both sacked; Mitchell went through long and tedious proceedings for alleged income-tax evasion, and the large pension Wiggin had thoughtfully arranged for himself was revoked. Ivar Kreuger went out one day in Paris, bought a gun, and shot himself. Harry Sinclair eventually went to jail, and so, for embezzlement, did Richard Whitney. Whitney's passage into Sing Sing, in dignified, dark-vested attire, wearing, it has been said, the Porcellian pig of his Harvard club, was one of the more widely circulated news portraits of the time.

The young professionals now engaged in much-admired and no less publicized trading, merger takeover, buy-back, and other deals, as they are called, will one day, we can be sadly sure, suffer a broadly similar fate. Some will go to jail; some are already on the way, for vending, buying, and using inside information. Given the exceptionally oblique line between legitimate and much-praised financial knowledge and wrongfully obtained and much-condemned inside information, more are known to be at risk. But for most the more mundane prospect is unemployment and professional obloquy, and for some, personal insolvency. Expensive apartments will become available on the upper East Side of Manhattan; there will be property transfers in the Hamptons. David Stockman, said by the press to have a car sent out for him to Connecticut each morning by his employer, may end up taking the train.

S. C. Gwynne, a young onetime banker, tells in his excellent book *Selling Money* of his services in the late seventies and early eighties to the international division of Cleveland Trust, now AmeriTrust, a relatively conservative player on the world scene. He journeyed from Manila to Algiers and Riyadh in search of loans. It was a time of admiring reference to the recycling of funds on deposit from the OPEC countries to the capital-hungry lands. And he tells us that

> by December 31, 1982, more than $200 million in loans would be in trouble in Mexico, Brazil, Venezuela, Poland, and the Philippines. . . . By 1984, thirteen of the seventeen officers who had staffed the [international] division in 1980 would be gone, and Ben Bailey, [the] deputy manager, and most of the members of the senior credit committee that approved the foreign loans would take early retirements.

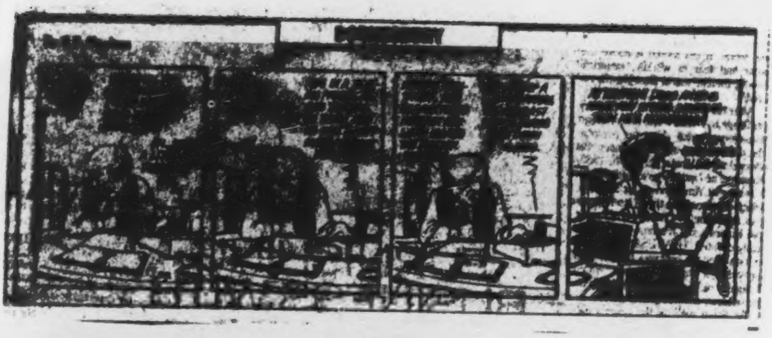
The end for those in the present play will come when either recession or a tight-money crunch to arrest inflation makes the debt load they have so confidently created no longer tolerable. Then there will be threats of default and bankruptcy, a drastic contraction in operations, no bonuses, a trimming of pay and payrolls, and numerous very, very early retirements. And from many who did not themselves foresee the result, there will be a heavy-handed condemnation of the failure to see that this would be the result. For those who engage in trading operations at the investment houses the day of reckoning could be when the market goes down seemingly without limit. Then will be rediscovered the oldest rule of Wall Street: financial genius is before the fall.

THE FINAL PARALLEL WITH 1929 IS A MORE GENERAL one; it has broadly to do with tax reduction and investment incentives. In the Coolidge years, as noted, Andrew Mellon reduced taxes on the affluent. The declared purpose was to stimulate the economy; more precise reference to saving, investment, and economic growth was for the future. The unannounced purpose was, as ever, to lessen the tax bite on the most bitten. By the summer of 1929 the economy was, nonetheless, stagnant—even in slight recession. (To this, rather than to the built-in inevitabilities of speculation, some economists looking for deeper substance later attributed the crash.) There is every likelihood that a very large part of the enhanced personal revenues from the the tax reduction simply went into the stock market, rather than into real capital formation or even improved consumer demand.

So again now. Funds have been flowing into the stock market to be absorbed by the deals aforementioned or the cost of making them. Some, perhaps much, of this money—no one, to be sure, knows how much—is from the supply-side tax reductions. Real capital spending is currently flat, even declining—a depressing fact.

From the mergers, acquisitions, and buy-backs, it is now reasonably well agreed, comes no increase at all in industrial competence. The young men who serve in the great investment houses render no service to investment decisions, product innovation, production, automation, or labor relations in the companies whose securities they shuffle. They have no real concern with such matters. They do float some issues for new ventures or expanded operations; one concedes this while noting again how dismal is the present showing on real capital investment. Mostly their operations absorb savings into an inherently sterile activity.

History may not repeat itself, but some of its lessons are inescapable. One is that in the world of high and confident finance little is ever really new. The controlling fact is not the tendency to brilliant invention; the controlling fact is the shortness of the public memory, especially when it contends with a euphoric desire to forget. □



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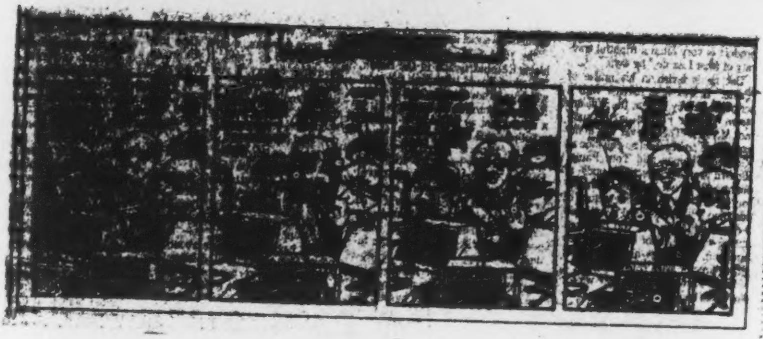

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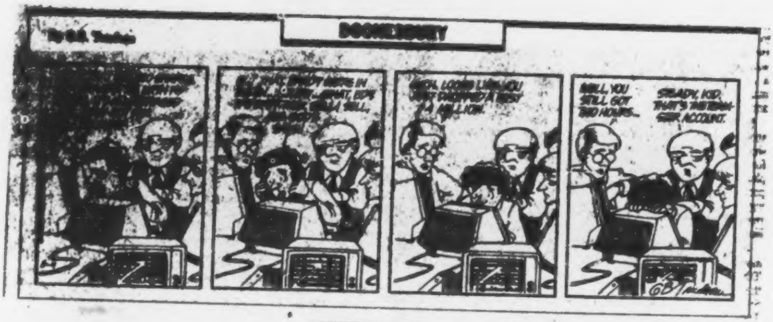
By G.B. Trudeau
DOONESBURY
GEEZ, LOOKS LIKE YOU JUST DROPPED A COOL $4 MILLION.
WELL, YOU STILL GOT TWO HOURS...
STEADY, KID. THAT'S THE TEAMSTER ACCOUNT.

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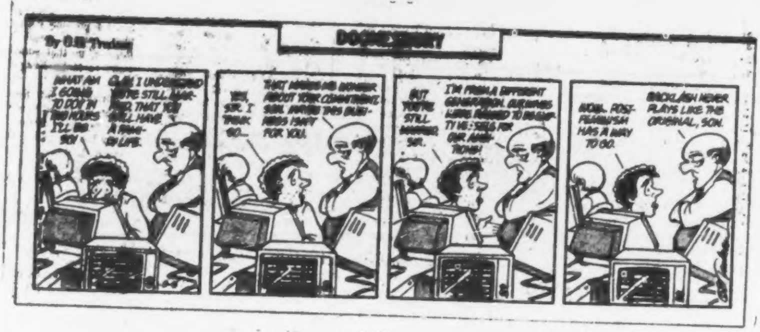
By G.B. Trudeau
DOONESBURY
WHAT AM I GOING TO DO? IN TWO HOURS I'LL BE 30!
CLARK, I UNDERSTAND YOU'RE STILL MARRIED, THAT YOU STILL HAVE A FAMILY LIFE.
YES, SIR. I THINK SO...
THAT MAKES ME WONDER ABOUT YOUR COMMITMENT, SON. MAYBE THIS BUSINESS ISN'T FOR YOU.
BUT YOU'RE STILL MARRIED, SIR.
I'M FROM A DIFFERENT GENERATION. OUR WIVES WERE TRAINED TO BE EMPTY VESSELS FOR OUR AMBITIONS!
WOW... POST-FEMINISM HAS A WAY TO GO.
BACKLASH NEVER PLAYS LIKE THE ORIGINAL, SON.

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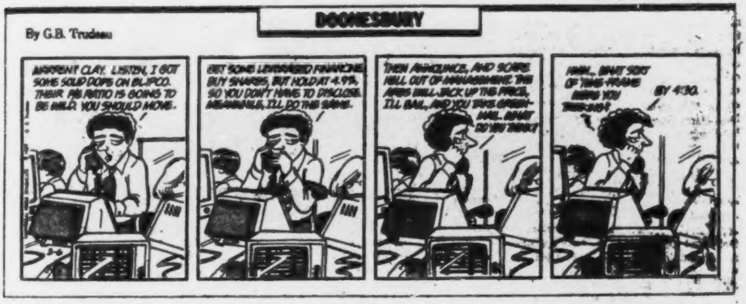
DOONESBURY
By G.B. Trudeau
WARRENT CLAY. LISTEN, I GOT SOME SOLID DOPE ON BLIPCO. THEIR P/E RATIO IS GOING TO BE WILD. YOU SHOULD MOVE.
GET SOME LEVERAGED FINANCING. BUY SHARES, BUT HOLD AT 4.9%, SO YOU DON'T HAVE TO DISCLOSE. MEANWHILE, I'LL DO THE SAME.
THEN ANNOUNCE, AND SCARE HELL OUT OF MANAGEMENT. THE ARBS WILL JACK UP THE PRICE, I'LL BAIL, AND YOU TAKE GREEN-MAIL. WHAT DO YOU THINK?
HMM... WHAT SORT OF TIME-FRAME WERE YOU THINKING?
BY 4:30.

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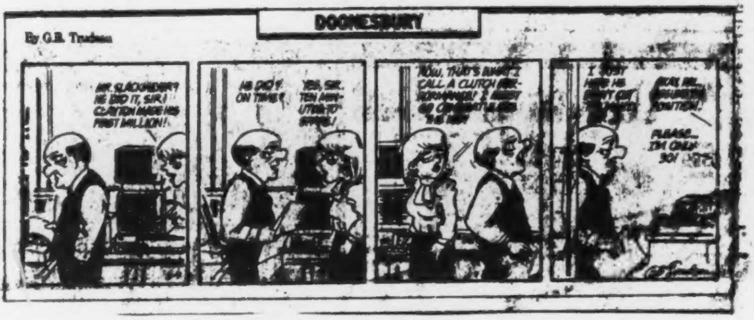
DOONESBURY
By G.B. Trudeau
MR. SLACKMEYER? HE DID IT, SIR! CLAYTON MADE HIS FIRST MILLION!
HE DID? ON TIME?
YES, SIR. TEN MINUTES TO SPARE!
NOW, THAT'S WHAT I CALL A CLUTCH PERFORMANCE! I MUST GO CONGRATULATE THE BOY!
I JUST HOPE HE [illegible]
[illegible] POSITION!
PLEASE... I'M ONLY 30!

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Exhibits Presented In Support Of Oral Testimony Of John J. Bavis, JR., Before The Committee On Banking and Finance, April 8, 1987

EXHIBIT #	DESCRIPTION
~~A.~~	~~Reprint Of Text Of Jack Bavis Oral Testimony~~ SEE PREVIOUS TESTIMONY
B.	Hastings-Murtagh Law Suit Verified Complaint (Particularly the underlined portions which spell out the manner in which the same was consummated.)
C.	Hastings-Murtagh Law Suit Amended Verified Complaint (Particularly the comments of Mr. F. Lee Bailey from pages 27 to 40)
D.	Hastings-Murtagh Law Suit Amended Verified Complaint
E.	Memorandum from Roland M. Attenborough, Attorney at Law, concerning the proposed acquisition of Eastern Air Lines, Inc., by Texas Air Corporation (6-page memo which highlights the major questionable activities in the sale)
F.	Center for Labor Research and Studies Impact Analysis of Proposed Income Reductions at Eastern Air Lines (Discussion paper on the impact to the Miami area of proposed changes in wage and personnel cuts at Eastern Air Lines.)
~~G.~~	~~Management Articles~~ ~~1. Top Gun by William P. Barrett; Texas Monthly, 3/87~~ ~~2. Safety Issue Plagues Lorenzo's Airline, Newsday, 1/18/87~~ ~~3. Lorenzo's Lieutenants Have Shaped the Industry Air Line Executive Magazine, Jan. 1987~~ ~~4. Kind words for Continental, Time, Jan. 1987~~
~~H.~~	~~Videotape - Employee Stock Ownership Plan, Bob Bumgarner (Particularly the first 1/2 hour, in which the history of the buyout is traced)~~
~~I.~~	~~Videotape - F. Lee Bailey (1/2 hr. discourse on the questionable business practices used in the purchase of Eastern Air Lines by Texas Air Corporation)~~

RETAINED IN COMMITTEE FILES

AIR LINE PILOTS ASSOCIATION ☐ EAL-MEC OFFICE
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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

EXHIBIT B

Elizabeth A. Hastings-Murtagh, Daniel P. Murtagh, E.A.L. Employees Coalition Acquisition Corp., an Florida Corporation, Charles E Bryan, Robert V. Callahan, and Larry Schulte,

Plaintiffs,

v.

Texas Air Corporation, a Delaware Corporation, Frank Lorenzo, Philip Bakes, Frank Borman, Joseph B. Leonard, Wayne A. Yeoman, Harry Hood Bassett, Peter O. Crisp, James A. Elkins, Jr., Karl Eller, John T. Fallon, Robert D. Lund, Enrique Madero, Thomas O. Paine, Wesley W. Posvar, Julian Scheer, Thomas R. Williams, David W. Wallace, Elmer L. Ward, Jr., TAC/EAL Acquisition, Inc., a Delaware Corporation, Eastern Air Lines Inc., a Delaware Corporation.

Defendants.

CASE NO.

Verified Complaint for Declaratory and Injunctive Relief

VERIFIED COMPLAINT

Elizabeth A. Hastings-Murtagh ("Hastings-Murtagh"), Daniel P. Murtagh ("Murtagh"), Charles E. Bryan ("Bryan"), Robert V. Callahan ("Callahan") and Larry Schulte ("Schulte") bring Counts I through III of this action derivatively on behalf of Eastern Air Lines, Inc. ("Eastern"). E.A.L. Employees Coalition Acquisition Corp. ("Coalition Corp."), brings Count IV of this action directly for its own benefit. Plaintiffs allege upon knowledge, information and belief, as follows:

[illegible]

1. On February 24, 1986, Eastern employees owned in excess of 25% of the common stock of the company -- they were collectively Eastern's largest shareholder. In the preceding months, Eastern's approximately 41,000 employees had been engaged in a vigorous campaign to purchase additional Eastern stock on the open market, in addition to the stock already owned by the employee trusts. However, without exploring in any respect the possibility of selling the company to Eastern's employees, or even contacting those employees or their representatives with whom they had ~~negotiated~~ in the past to see what interest they might have in acquiring the Company, Eastern was "sold".

2. On February 24, 1986, at 2:30 a.m., the Board of Directors of Eastern ("Board") precipitously approved an inadequate take-it-or-leave-it merger proposal from Texas Air Corporation ("Texas Air") that had been presented to the Board for the first time only twelve hours earlier. All of the directors present, except four who had been designated by the three employee unions, voted to preclude all other potential bidders for Eastern by ① agreeing to finance the acquisition by Texas Air of a large block of newly issued Eastern common stock, ② issuing to Texas Air a stock "look-up" option and ③ agreeing to an ironclad "no-shop" provision, although this was the first and only offer solicited by the company. At the same time, the defendant directors authorized Texas Air to acquire additional Eastern shares in the open market which, when added to the lock-up shares financed by Eastern and those shares subject to the lock-up option, would give Texas Air [illegible] of Eastern's outstanding [illegible] and the power to approve the merger -- even if all other Eastern shareholders voted against it. Further, Texas Air was permitted to pay for Eastern by refinancing Eastern's assets and pledging its income. Texas Air induced Eastern's Board to conclude the transaction on Texas Air's terms, without considering its consequences or investigating alternatives and in disregard of the shareholders' interests, by agreeing to provide Eastern's directors $35 million of indemnification.

3. The expressed interest of representatives of Eastern's employee shareholders in making a bid to buy the company were ignored. Following Texas Air's agreement to indemnify them, the defendant directors approved the merger proposal with only the most cursory review of its terms, and over the refusal of the outside directors' own investment banking firm to issue a fairness opinion before the deal was struck. In approving the Texas Air merger proposal while effectively nullifying any real opportunity for stockholders to vote down the transaction and locking out all other bidders for Eastern, the defendant directors were grossly negligent and breached their duties of loyalty and care, all to the irreparable detriment of Eastern, its shareholders, and its employees.

4. Furthermore, as described herein, the proxy statement issued in connection with the proposed merger is deceptive and misleading in material respects, and it fails to include information required by Securities and Exchange Commission rules.

5. The financial [illegible] immediately [illegible] that the Texas Air proposal enriched Texas Air at the expense of Eastern shareholders. Texas Air's stock soared over 30% within a week of the announcement of the merger.

6. Plaintiffs bring this action for injunctive and declaratory relief to remedy violations of the Securities Exchange Act and to restrain consummation of the merger; to invalidate the merger agreement, including the inducement fee, the no-shop provision, the lock-up option, and Texas Air's purchases of Eastern stock, all of which were approved by the defendant directors in violation of their fiduciary obligations and Delaware law; to postpone the holding of a stockholders' meeting of Eastern presently scheduled for November 25, 1986; to enjoin Texas Air from voting its unlawfully acquired Eastern shares at any Eastern stockholder's meeting; and to direct the Eastern Board in good faith to consider a pending competing offer of plaintiff Coalition Corp. which is clearly superior to the Texas Air offer and in the best interests of all Eastern shareholders.

Jurisdiction and Venue

7. This Court has jurisdiction over Count I under Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa. This Court has jurisdiction over Counts II through IV under principles of pendent jurisdiction, inasmuch as such claims arise out of the same nucleus of operative facts as the Federal claims.

8. In connection with the acts and conduct alleged in this Complaint, the defendants, directly or indirectly, used the

mails, the instrumentalities of interstate commerce and the facilities of national securities markets.

9. Venue is proper in this district pursuant to 28 U.S.C. 1391. Many of the acts alleged herein occurred in the Southern District of Florida, and the claims as alleged herein arose in this District. The principal place of business of Eastern is in Dade County and among other events the Board meeting on February 23-24 took place at company headquarters.

10. Plaintiffs seek a declaratory judgment pursuant to 28 U.S.C. §2201.

Demand Excused

11. No demand has been made on Eastern's Board to bring this action, and demand is excused in these circumstances for the following reasons:

(a) Certain of the Directors are recipients of golden parachutes under the Texas Air Merger Agreement and previous resolutions of the Board, and therefore have a personal interest in the Texas Air merger being completed. A director's interest in such payment renders demand futile.

(b) The pattern of conduct alleged above, including the Board's persistent refusal to cooperate in any way with Eastern employees in connection with an acquisition effort which the employees were clearly able and prepared to make -- and have now made -- upon terms superior to those offered by Texas Air, repeated warnings to Plaintiff Bryan to cease any activity inconsistent with the no-shop provision, the unrelenting hostility of certain Board members to certain [illegible] of [illegible] and the existence of two Texas Air executives on Eastern's Board and in management, make it apparent that any demand would be futile.

(c) Texas Air has claimed majority stock ownership.

Parties

12. Plaintiff Martinez-Murtagh was at all relevant times an owner of common stock of Eastern. She also owns 10 depository preferred shares. Further, on February 11, 1986, she bought and additional 1,400 shares of Eastern common which she sold on May 23, 1986.

13. Plaintiff Murtagh was at all relevant times an owner of common stock of Eastern. Further, he owns depository preferred shares and certificates of warrant.

14. Plaintiff Coalition Corp. is a newly formed Illinois corporation, formed to facilitate the acquisition of Eastern by merger on behalf of its employees. Its initial shareholders are Eastern's employee unions.

15. Plaintiff Bryan was at all relevant times an owner of common stock of Eastern, an Eastern employee, President and General Chairman of District 100 of the International Association of Machinists and Aerospace Workers ("IAM"), which represents approximately 12,000 Eastern machinists, a Director of Eastern, and is an officer of Coalition Corp.

16. Plaintiff Callahan was at all relevant times an owner of common stock of Eastern, is an Eastern employee, and President of Transport Workers Union ("TWU") Local 553, [illegible] Eastern [illegible], a Director of Eastern, and is an officer of Coalition Corp.

17. Plaintiff Schulte was at all relevant times an owner of common stock of Eastern, an Eastern employee, President of the Air Line Pilots Association, International ("ALPA"), Eastern Air Lines Master Executive Counsel, which represents Eastern's pilots and certain other personnel, and is an officer of Coalition Corp.

18. Texas Air is a Delaware corporation, with its principal executive offices in Houston, Texas. Texas Air is a holding company, the principal holdings of which are a majority position in Continental Airlines, and all of the common stock of New York Air, CCS Automation Systems, Inc. and Texas Air Leasing Corporation. In addition, Texas Air has agreed to acquire People Express and has acquired assets of Frontier Airlines.

19. TAC/EAL Acquisition, Inc. is a Delaware corporation. It is a wholly owned subsidiary of Texas Air, and was formed for the purpose of acquiring Eastern.

20. Defendant Francisco "Frank" Lorenzo ("Lorenzo") is Chairman of the Board and Chief Executive Officer of Texas Air and of Continental Airlines, and on October 17, 1986, was elected by Eastern's Board to be its Chairman.

21. Defendant Philip Bakes ("Bakes") was, until October, 1986, President of Continental Airlines. On October 17, 1986, the Eastern Board elected Bakes as President and Chief Executive Officer, and a Director of Eastern.

22. Texas Air, [illegible], [illegible] and TA [illegible] Acquisition, Inc., conspired with and aided and abetted the defendant directors in breaching their fiduciary duties to plaintiff and Eastern's other shareholders and are liable together with the other defendants for the wrongful acts alleged herein.

23. Defendant Frank Borman ("Borman") was Chairman of the Board, Chief Executive Officer and a Director of Eastern until his resignation, effective as of July 1, 1986, at which time he became a Director and Vice Chairman of Texas Air.

24. Defendant Joseph B. Leonard was President, Chief Operating Officer and a Director of Eastern and also became acting Chief Executive Officer, effective July 1, 1986, until he was replaced by defendant Bakes at the direction of defendant Lorenzo. Leonard voted to accept the Texas Air offer.

25. Defendant Wayne A. Yeoman was Senior Vice President-Finance and a Director of Eastern, and voted to accept the Texas Air offer.

26. Defendant Harry Hood Bassett is a Director of Eastern, and voted to accept the Texas Air offer.

27. Defendant Peter O. Crisp is a Director of Eastern, and voted to accept the Texas Air offer.

28. Defendant James A. Elkins, Jr., is a Director of Eastern, and voted to accept the Texas Air offer.

29. Defendant Karl Eller is a Director of Eastern, and voted to accept the Texas Air offer.

30. Defendant John B. [illegible] is a Director of Eastern, and voted to accept the Texas Air offer.

31. Defendant Robert D. Lund is a Director of Eastern, and voted to accept the Texas Air offer.

32. Defendant Enrique Madero is a Director of Eastern, and voted to accept the Texas Air offer.

33. Defendant Thomas O. Paine is a Director of Eastern, and voted to accept the Texas Air offer.

34. Defendant Wesley W. Posvar is a Director of Eastetn, and voted to accept the Texas Air offer.

35. Defendant Julian Scheer is a Director of Eastern, and voted to accept the Texas Air offer.

36. Defendant Thomas R. Williams is a Director of Eastern, and voted to accept the Texas Air offer.

37. Defendant David W. Wallace is a Director of Eastern, and voted to accept the Texas Air offer.

38. Defendant Elmer L. Ward, Jr., is a Director of Eastern, and voted to accept the Texas Air offer.

39. Eastern is a corporation organized and existing under the laws of the State of Delaware, with its principal executive offices in Miami, Florida. Eastern is a commercial airline, flying domestic and international routes. It ranks as the second largest air carrier in the free world based upon the number of passengers carried, and the third largest certificated United States air carrier based upon scheduled revenue passenger miles flown domestically and internationally.

[illegible] Lorenzo, Bakes, Texas [illegible] Acquisition, Inc., on and after February 24, 1986, were, individually or in conjunction with others, controlling persons of Eastern within the meaning of Section 20 of the Securities Exchange Act of 1934 and were affiliates of Eastern within the meaning of Section 12(e) of the that act. Each of the director defendants except Lorenzo and Bakes was, individually or in conjunction with others, such a controlling person of Eastern at all pertinent times.

Facts Common to All Counts

Background

41. Since the late 1970's, Eastern's financial performance and its performance in the marketplace have lagged the performance of many of its competitors. Eastern's management has been unable to effectively address the economic and competitive pressures which have prevailed in the industry as a whole.

42. Eastern's failure to achieve financial stability and to achieve the competitive success experienced by other airlines of comparable size has occurred despite Eastern's possession of a number of uniquely valuable assets. These include a sophisticated computerized reservation system, a profitable and dominant Eastern Seaboard (Boston - New York - Washington) shuttle service, a wealth of valuable landing "slots" at volume-controlled airports, valuable South American routes acquired from Braniff, and a major hub in Atlanta which, while shared with another large airline, has been free of any significant fare wars.

43. Eastern management has consistently responded to its economic and competitive problems by demanding that its employees agree to wage and other concessions. Eastern management has continually threatened to put the company into bankruptcy or to take other steps that would have effectively resulted in the elimination of the company and the jobs of its employees if the employees did not agree to such concessions. In some instances, in consideration of such concessions, Eastern's employees have acquired shares of the common stock of the company or other rights to share in the profits of the company, and have achieved representation on its Board, and have otherwise obtained the right to participate in the management of Eastern. As a result, Eastern's employees have gradually become significantly involved in the management of Eastern, and the possibility of the employees purchasing the company has crystallized as a viable alternative and a solution to its financial problems.

(a) From 1977 to 1982, Eastern's employees contributed about $150,000,000 to Eastern's operations through wage concessions. In two of these years, these employees received a share of Eastern's profits in return for these concessions; the profits received by the employees in this manner were $140,000,000 less than the concessions obtained by the company. In 1980, each Eastern employee received 10 shares of common stock of Eastern in lieu of any cash distribution pursuant to Festern's Variable Earnings Program.

(b) In [illegible] the Investment Bonus Agreement was [illegible] pursuant to which, in return for wage concessions, Eastern's employees were to receive a percentage of the company's profits.

(c) In June of 1983, after Eastern management threatened to place the company in bankruptcy, Eastern employees were encouraged to make voluntary contributions to the Investment Bonus Agreement and the employees agreed to defer some retroactive pay to which they were entitled. In addition, the pilots agreed to accept convertible subordinated debentures in return for wage concessions. The pilots were also allowed to appoint two members to Eastern's Board.

(d) In September of 1983, Eastern management again threatened to place the company in bankruptcy if the employees did not agree to a 20% wage reduction and a waiver of accrued vacations. Eventually, the employees agreed to an 18% wage deduction pursuant to which the wages so deducted were to be used to purchase 12,000,000 shares of Eastern common stock and an additional 3,000,000 shares of preferred stock which was eventually to be converted into an additional 3,000,000 shares of common stock. This program was referred to as the Wage Investment Program. As a result of the Wage Investment Program, Eastern employees acquired the ownership of 25% of Eastern's common stock and collectively were by far the largest shareholder of the company.

(e) In addition to obtaining the right to purchase up to 15,000,000 shares of the common stock of the company, under the Wage Investment Program, through trusts established for members of Eastern's three major unions the employees also received preemptive rights to purchase additional shares of the common stock of the company in the event of future stock offerings.

(f) In the fall of 1983, Eastern management also agreed that the flight attendants (TWU) and the machinists (IAM) would each be entitled to appoint one representative to Eastern's Board of Directors. These seats were in addition to those previously granted to the pilots (ALPA) and brought the total number of employee seats on the Board of Directors to four. Eastern's management also agreed that Eastern's employees would be entitled to review Eastern's financial records on a regular basis and would be consulted regarding a variety of management decisions before they were made.

(g) The Wage Investment Program pay deductions were originally scheduled to terminate on December 31, 1984. However, Eastern management unilaterally announced in late 1984 that the company would continue the 18% wage deduction throughout 1985, but without any provision for additional purchases of Eastern common stock on behalf of the employees. On February 7, 1985, Eastern management again threatened to place the company in bankruptcy unless the employees agreed to the continuation of the Wage Investment Program as amended. The machinists agreed to the continuation of the concessions with the proviso, however, that the wage cuts were to be restored if certain production efficiencies were realized.

(h) In the 1983 negotiations over the Wage Investment Program, the unions requested that they be given a right of first refusal with respect to the company's stock in the event of the proposed sale of the company to some third party. No agreement was reached to provide the unions with such a right of first refusal.

(i) In the fall of 1985, the machinists agreed to an additional 5% wage concession.

(j) By the end of 1985, Eastern employees had contributed more than $900,000,000 in wage and other concessions to the Company over the past decade. They also had four seats on the Board and owned in excess of 25% of the common stock of the company.

44. In early 1986, all three Eastern unions embarked upon an extensive public campaign to encourage their members and non-union employees to purchase Eastern common stock for the purpose of increasing the influence of the employees in the management of the company. The three unions formed a coalition which in turn filed a Form 13(d) with the Securities and Exchange Commission on January 30, 1986 disclosing their intent to increase the extent of employee ownership of the common stock of the company. *

45. These actions were interpreted by Eastern management as an effort by the employees and the unions to obtain a majority

of the stock of the company. At the Board meeting of January [illegible] 1986, Plaintiff Bryan was confronted by Eastern management and directed to explain his intentions with respect to the purchase of a controlling interest in the company. Similarly, union representatives were denied access to financial and other information relating to Eastern which they had previously been allowed to examine, because management was concerned that such information might be used to further an effort to buy control of Eastern. "Poison Pill" provisions were adopted January 31, 1986 by the Board to thwart any employee effort to acquire control of the company. * 3 WEEKS BEFORE LORENZO DEAL

46. Earlier, in November, 1985, Eastern instructed its investment banker, Merrill Lynch Capital Markets ("Merrill Lynch"), to prepare a valuation study of Eastern to facilitate an evaluation of options regarding the sale of some or all of Eastern or its assets.

47. In June, 1985, and at various times thereafter prior to December, 1985, Borman informally explored the possibility of a sale or merger with a number of parties without advising the Board or representatives of Eastern's employees. Among the companies contacted was Texas Air, which expressed an interest in pursuing discussions.

48. Despite the demonstrated interest of representatives of Eastern employees -- collectively the company's largest shareholder -- Borman failed to explore the possibility of an employee purchase of the company. A strategy not grounded in any legitimate business purpose led Borman to fail to contact any of the leaders

of Eastern's unions with respect to a possible employee purchase as had been done in the past. Subsequently, the likelihood that golden parachute provisions agreed to by Eastern's Board would not survive negotiations with an employee group also contributed to Borman's continued disregard of the acquisition interests of Eastern's employees.

The Texas Air Contacts

49. On December 4, 1985, Borman met with Lorenzo. They discussed the possibility of a friendly acquisition of Eastern by Texas Air, and agreed to meet at an early date. Borman agreed to provide Lorenzo with certain confidential financial projections.

50. Borman on information and belief intended to use the threat of a takeover by Lorenzo as a coercive measure to force concessions from Eastern's three major unions. In fact in October 1985, the unions publicly predicted this strategy. (Lorenzo was well known in the industry as the individual responsible for thwarting the efforts of employees of Continental Airlines to purchase that troubled airline in 1983, by buying the airline and placing it into bankruptcy, thereby abrogating union contracts).

51. On December 10, 1985, Borman and Lorenzo met again to discuss the possibility of a Texas Air offer. Prior to this meeting, Borman had provided Texas Air with confidential financial documents of Eastern. At the December 10 meeting, Lorenzo again indicated an interest in a Texas Air acquisition of Eastern, if such an offer would be welcomed by Eastern's management.

[illegible]

52. During ongoing collective bargaining negotiations, TWU established a strike deadline of January 10, 1986, and ALPA a February 16, 1986, deadline. The collective bargaining agreement with IAM had approximately 10 months to run.

53. ALPA and TWU informed Borman in January, 1986, that they were willing to consider substantial wage reductions in new collective bargaining agreements.

The Texas Air Negotiations

54. According to the Proxy Materials, on February 14, 1986, Eastern's executive committee authorized Merrill Lynch to contact Texas Air to indicate Eastern might be open to merger discussions in the near future.

55. At a Board meeting on February 21, 1986, Borman indicated that a "specific entity" had expressed interest in acquiring Eastern. Borman refused to reveal that the entity was Texas Air, because he claimed Lorenzo had threatened to withdraw from any possible transaction if Texas Air's identity were disclosed. The Board blindly passed a resolution directing Borman to pursue discussions with that "entity."

56. Eastern management had recognized the potential attractiveness of Eastern to potential buyers when it adopted certain "poison pill" provisions in January, 1986, designed to act as a shield against "unwanted" bids for the company, including bids which might be made by the employees.

57. Unbeknownst to Board members Bryan, Callahan and to some other members of the Board, Borman already had made

[illegible] to produce an offer from Texas Air on a moment's notice as the February 23 strike deadline with ALPA approached. Almost immediately after the February 22 Meeting was adjourned, Borman placed a single, pre-arranged telephone call to Lorenzo, who offered to purchase Eastern on behalf of Texas Air. Lorenzo imposed a 48-hour deadline on Eastern's Board to accept his offer. Borman immediately agreed to present Lorenzo's offer to the Board.

58. Despite the impending deadline placed by Lorenzo on the Texas Air proposal, Borman did not immediately present it to the Board. Rather than meeting with the Board, on February 22 Borman met with the leaders of ALPA, IAM and TWU. He announced Lorenzo's offer and stated that it would remain open only until midnight, February 23. Borman then delivered an ultimatum: either the unions would enter into the concessionary labor contracts previously demanded by Eastern management prior to Lorenzo's deadline, or the Board would sell the company.

The February 23 Board Meeting

59. At 2:00 p.m. on February 23, 1986 -- almost 48 hours after the proposal was communicated to Borman and within 10 hours of the deadline imposed by Lorenzo -- a meeting of Eastern's Board was convened to consider Texas Air's merger proposal. Although no written merger agreement was made available to the Board at that time, Eastern's counsel briefly described the terms of the proposed deal to all of the members of the Board, except Willie C. Robinson, who was not present. According to the Texas Air proposal, Eastern would be the surviving company following the merger of a wholly owned Texas Air subsidiary into Eastern. Eastern's shareholders would receive for each share of Eastern common stock (i) $4.50 in cash; (ii) $1.75 in cash to be realized from the sale of certain Eastern securities; and (iii) junk bonds to be issued by Eastern with a face value (but not a market value) of $3.75.

60. During the Board meeting, representatives of Merrill Lynch briefed the Board on the Texas Air offer, and on the results of the Merrill Lynch valuation study which had been commissioned in November, 1985. The valuation study reflected current (at the time of the study) labor costs and did not take into account possible realignment or redeployment of assets to enhance value. Wage concessions which were, in fact, tentatively agreed to by two unions during the weekend negotiations were deemed "speculative" by Merrill Lynch, and were not considered in Merrill Lynch's valuation report. Nor did the valuation assess the likelihood of a potential offer for Eastern at any particular price level, the likelihood of a potential offer coming in a particular form of consideration or structure, or the likely acceptability of any particular offer to the Board. The valuation study was "theoretical in nature," as Eastern admits in its Proxy Materials.

61. The Board failed to give Merrill Lynch any guidelines to follow in preparing the valuation study. The study was prepared before the terms of any bid had been presented to the Board. Despite the admittedly theoretical nature of the valuation report, the Board failed to require a revised valuation

report specifically addressing issues relevant to the proposed merger, including the achievement of significant labor concessions, a substantial reduction in fuel costs which was an unfolding circumstance at the time of the merger, and the value of Eastern's wealth of "slots" at volume-restricted airports, the marketability of which was also an unfolding development at the time of the merger. Other valuable assets of Eastern were simply not included in the valuation report.

62. Inadequate and misleading as it was, the valuation study nonetheless indicated a potential value for Eastern as high as $10.81 per common share if Eastern were sold as a whole, and as high as $13.41 per share if Eastern assets were sold on a segment-by-segment basis.

63. After counsel's presentation of the terms of the proposal, which lasted only about one hour, Borman acknowledged that concessionary labor agreements with ALPA, IAM and TWU would be preferable for Eastern and its shareholders to the proposed merger with Texas Air.

64. The meeting was adjourned at approximately 5:00 p.m. When it reconvened at 7:30 p.m., a proposed draft merger agreement was distributed for the first time to Eastern's directors. In addition, Merrill Lynch reviewed the proposed transaction with the directors.

65. Merrill Lynch refused to render a fairness opinion that took into account the effect of substantial ALPA and TWU wage concessions -- concessions which provided over $200 million in savings to Eastern.

66. Salomon Brothers, retained to act as the financial advisor to Eastern's outside directors, refused to issue any fairness option at that time. However, Salomon representatives advised the Board that a $10 price might be in the lower range of fairness, but that cost savings from the agreement reached with ALPA and cost savings from other agreements that might be made would increase the value of the Company.

67. The meeting was adjourned again, and reconvened at 10:30 p.m. Defendant Fallon, Chairman of Eastern's Executive Committee, reported on the negotiations with Texas Air. Defendant Turner, in response to director concerns, then reported that Texas Air had agreed, among other things, to provide $35 million of indemnification to Eastern's directors in connection with their approval of the merger, and to extend the acceptance deadline to 4:00 a.m.

68. During the adjournment, IAM, the only union with substantial time (some 20 months) remaining on its existing contract, indicated to two directors that while it was not willing to reopen its contract, it was willing to take other cost-saving steps. The directors indicated that another 15% in savings would be sufficient. The Board was advised by the IAM that such savings were assured. Even though these savings would have provided the Board (in combination with the agreed-to ALPA and TWU concessions) with everything it had sought to keep Eastern independent, this proposal was rejected in order not to embarrass Borman. The Board then recessed.

69. Borman failed to reveal, and the Board did not appreciate that, in light of the labor concessions which had been agreed to by ALPA and TWU, bankruptcy was no longer (if it ever was) an unavoidable alternative to a shotgun marriage with Texas Air. In a press release to be issued by Eastern upon acceptance by Texas Air, Eastern's general counsel perpetuated the deception, stating that the IAM "would not agree to consider any cost relief for the airline whatsoever," and that the only alternative to the Texas Air deal would have been a Chapter 11 bankruptcy filing. These statements were made despite the clear record that the IAM had given assurance of "cost relief," and that a bankruptcy filing would not have been necessary in light of the other union's concessions.

70. At 2:25 a.m., the Board reconvened and a majority of the Board, armed with the personal blandishments proposed by Texas Air and acting out of self-interest and a desire to entrench Borman and other members of Eastern's management in their positions, approved the merger between Texas Air and Eastern. Later that day, Eastern and Texas Air executed an Agreement and Plan of Merger dated February 24, 1986 (the "Merger Agreement"). In their haste, the defendant directors failed to fully inform themselves of the information necessary to make an informed decision

and therefore violated the fiduciary duty of care. The Board approved the Merger Agreement without reviewing any of the valuation documents distributed by Merrill Lynch at the February 23 meeting; without seeing the final document; without requesting or obtaining a more relevant valuation report or any additional fairness opinions; without any discussion of the purpose or effect of the $20 million inducement fee, Texas Air's "purchase" of 10.9 million newly issued Eastern shares, the lock-up option, the no-shop provision, the quality of the junk bonds to be issued by Eastern, the adequacy of merger consideration, or the intrinsic value of the company; and without seeking to determine whether a higher price could be obtained for the company from its employees or others, and whether the Texas Air proposal was the best way to maximize value to the shareholders.

71. On February 26, 1986, at a joint news conference with Lorenzo to announce the Merger Agreement, Borman publicly admitted that the effect of the Texas Air proposal would be to entrench him and other members of Eastern's management. Specifically, Borman conceded that he and Lorenzo had reached an "understanding" that he and other members of Eastern management would remain entrenched in their positions in control of Eastern following the merger:

> "Let's be candid," Mr. Borman remarked at one point during the news conference, "Mr. Lorenzo and I have an understanding."
>
> Eastern, he said, would be a subsidiary. "It will be operated as a separate entity with management in place," Mr. Borman said.

N.Y. Times, Feb. 26, 1986, at D1, col. 3.

The Texas Air Merger Agreement

72. The financial terms of the Merger Agreement are as follows:

(a) Eastern agreed to sell to Texas Air, and has sold, 10,935,000 shares of common stock at a stated price of $6.25 per share - $3.13 per share to be paid in cash and $3.12 per share to be paid by a 14.125% promissory note due in 1991. As part of the Merger Agreement, Eastern also agreed to (and did) pay to Texas Air a non-refundable "inducement fee" of $20 million. Thus, at the closing of this transaction, a $34.2 million check was written to Eastern by Texas Air, and a $20 million check was written to Texas Air by Eastern, resulting in a net payment to Eastern for the 10,935,000 shares of $14.2 million, or approximately $1.30 per share. The "inducement fee" was actually a thinly veiled arrangement whereby Eastern virtually gave away 18 1/2% of its stock.

(b) Texas Air agreed to purchase Eastern's outstanding common stock for a per share price of $6.25 in cash - $4.50 per share from Texas Air and $1.75 per share from Eastern, plus $3.75 per share principal amount of a new 11.36% cumulative junior preferred stock of Eastern. The market value of the convertible preferred will be substantially less than $3.75.

73. Eastern granted to Texas Air an irrevocable option (the "Lock-Up Option") to purchase an additional 10 million shares,

or approximately 17% of the shares outstanding, at a price equal to $7.50 per share. The option would be triggered in the event that, among other things, any person or group, other than Texas Air, acquired more than 5% of Eastern's outstanding shares. Moreover, Texas Air would have the right to purchase shares in the open market, provided that its total holdings, including the option shares, did not exceed 51% of the total number of shares outstanding. The Lock-Up Option was later amended to allow Texas Air to purchase up to the lesser of 10,000,000 shares or that number of shares which would enable Texas Air to own up to 51% of the voting power of Eastern of authorized but unissued common stock at a price of $7.50 per share through December 31, 1986, or through April 30, 1987 under certain circumstances. Texas Air was, therefore, at the time of the Merger Agreement, assured of being able to acquire a majority voting interest in Eastern.

74. Eastern also agreed to a provision which negated any possibility of an auction for Eastern's stock, despite the knowledge of Frank Borman and the Board that Eastern employees were interested in buying Eastern. This provision (the "No-Shop Provision") sets forth Eastern's agreement that neither the company nor any of its officers shall solicit or encourage any offer to acquire the business and properties or capital stock of Eastern or disclose any information not customarily disclosed to the public concerning Eastern to a prospective buyer, or afford access to Eastern's books or records or otherwise negotiate with, facilitate, encourage or assist any person preparing to make or who has made an offer, or to enter into any agreement with any

third party providing for a business combination, equity investment or sale of a significant portion of Eastern's assets.

75. The net effect of these arrangements is to abrogate the right of Eastern's other shareholders to vote on Texas Air's proposed merger and to place that right solely in the hands of Texas Air. Under the provisions of Eastern's Certificate of Incorporation, a proposed business combination involving Eastern ordinarily must be approved by the affirmative vote of at least 80% of the stock entitled to vote with respect to the transaction, and at least 50% of the stock not held by a "controlling shareholder," i.e., the beneficial owner of at least 20% of the company's stock. However, a merger proposal accepted by two-thirds of Eastern's directors before the offeror became a "controlling shareholder" need be approved by only 51% of the outstanding shares of Eastern common stock. Thus, Texas Air's merger proposal, approved before Texas Air became a "controlling shareholder," was structured so that Texas Air would be assured the ability to secure approval of the merger, even if every single Eastern shareholder other than Texas Air voted to reject it.

76. Texas Air agreed to honor "golden parachutes" approved by Eastern in January of 1986 for 21 officers of Eastern. These agreements provide that if, within two years after a "change in control" of Eastern, their employment is terminated for any reason other than "cause" or on account of death, disability or normal retirement, they are entitled to payments of three (3) times the sum of such officers' (i) highest compensation in effect during the twelve month period preceding

such termination, and (ii) the highest annual bonus awarded to such officer during the twenty four months ended on the date of such termination. Such payments would also be payable if the officers' duties and responsibilities are substantially reduced. These golden parachutes range in amount from a high of $684,000 to a low of $216,144 based upon current compensation, for a maximum total amount of $7,347,900. In addition, such agreements provide for cashing out of the officers' stock options and for continuation for up to three years of their life insurance, medical and dental benefits, and the retention by such officers of their pass privileges for flying on Eastern.

77. The inadequacy of the financial terms of the Texas Air merger was immediately recognized by the stock market. The market price of Texas Air's common stood at $16¼/share on February 20, 1986 (immediately before the Board directed commencement of merger negotiations) and at $27 3/4/share, on March 3, 1986 (one week after the announcement of the merger), a 70.77% increase in Texas Air's market value, attributable only to marketplace recognition that Eastern was transferring valuable assets to Texas Air at a fire sale price, at the expense of Eastern and its shareholders.

Effect of No-Shop Provision and Lock-Up Option

78. Eastern's Directors followed a course of action and embraced a Merger Agreement which effectively thwarted the possibility of there being any auction for Eastern. Having contacted only one potential buyer with a specific request for a bid, the Board then proceeded to enter into an agreement with

that buyer - Texas Air - which on its face and in effect precludes the Board from seeking other bidders, assisting in any way other bidders, or agreeing to the terms of any other bid.

79. On at least three separate occasions, Plaintiff Bryan has sought to obtain for the Eastern employees an opportunity to negotiate for the purchase of Eastern. On each occasion, the Board has refused to even discuss such a purchase, due to the Texas Air agreement. The occasions were as follows:

(a) During the negotiations with Texas Air, Mr. Bryan asked for the opportunity to make a bid for Eastern, which request was rejected.

(b) On August 29, 1986, Mr. Bryan proposed to Eastern that the Eastern employees be provided an opportunity to purchase Eastern for $10.25 per share. Eastern refused to pursue the matter with Mr. Bryan on the grounds of the prohibition contained in the No-Shop Provision, despite the fact that the indicated offer was significantly superior to the Texas Air offer.

(c) Again, on October 16, 1986, Mr. Bryan asked the Board to agree to give "serious consideration to any proposal for the acquisition of Eastern . . . presented to the Board on behalf of Eastern . . . employees within the next sixty days." Relying upon the No-Shop Provision, the Board of Directors refused to adopt Mr. Bryan's resolution.

80. The No-Shop Provision and Lock-Up Option and adherence to such clauses by the Eastern Board have resulted in a

failure to maximize the company's value at a sale for the shareholders' benefit.

81. The continued adherence to the No-Shop Provision by the Board has resulted in the self-imposed inability of the Board to consider whether the Texas Air offer is fair in light of current circumstances in the industry, including a generally higher fare structure and the pending elimination of People Express as a major low-fare competitor in many of Eastern's markets, which will occur upon Texas Air's acquisition of People Express.

82. The Eastern Board has also precluded its own consideration of the increased value of Eastern based upon: (1) labor costs which the Eastern employees as buyers of Eastern would have within their own control; (2) actual financial results for the second and third quarters of 1986 and current projections.

83. Ignoring the Eastern employees' desire to bid for Eastern, Eastern's Board then embarked upon a course of action which has wasted corporate assets, to the benefit of Texas Air. Specifically, it has taken the following actions:

(a) Eastern has sold to Pan Am certain of its landing rights at New York's LaGuardia Airport and Washington's National Airport, prior to consummation of the merger, in response to the Department of Transportation's ("DOT") concerns regarding the elimination of competition in Eastern seaboard "shuttle" routes resulting from the common ownership of competitors New York Air and Eastern which would result from a Texas Air acquisition of Eastern. This sale of valuable assets (Eastern has retained certain reversion rights subject to DOT approval) occurred despite the knowledge of Eastern's Board that the No-Shop Provision and Lock-Up Option were unenforceable under Delaware law and that at least one other bidder-- the employees -- whose purchase of Eastern would not raise competitive concerns, was prepared to offer shareholders more for their stock than Texas Air;

ⓑ Approved the sale by Eastern to Texas Air of a DC-10-30 at a price below the price which would have been obtained for that aircraft in an arms-length transaction;

ⓒ Allowed Texas Air to buy Eastern stock on the open market at a lower price than would otherwise have been available, because the No-Shop Provision and Lock-Up Option lessened the prospects of a bidding war for Eastern.

ⓓ Amended the merger agreement to permit Texas Air to acquire 51% of Eastern common stock through open market purchases rather than investing new capital in Eastern by buying the "Lock-Up" amounts from Eastern.

ⓔ Making premature operational changes in anticipation of a combination with Texas Air units, including modifications to its computer systems, and elimination of a Miami-London route.

The Coalition Corp. Offer

84. On November 10, 1986, Plaintiff Coalition Corp. offered to acquire Eastern in a merger transaction in which the

common stockholders of Eastern will receive $10.25 in cash for each share of common stock.

Count I

(Brought by Plaintiffs Hastings-Murtagh, Murtagh, Bryan, Callahan and Schulte against all defendants under Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9 thereunder)

85. Plaintiffs reallege and repeat the allegations of paragraphs 1 through 84 above.

86. The conduct of defendants as set forth herein, as well as in other regards, was in violation of Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 14a-9 thereunder in that the acts, conduct and transactions referred to herein ⓐ operated as a fraud upon plaintiffs; ⓑ made various untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading to the plaintiff; and ⓒ constituted manipulative acts or courses of conduct, including but not limited to the fact that Section 6.6 of the Merger Agreement referred to, *inter alia* in paragraph [illegible]3 above constituted an illegal "lock-up" device which effectively guaranteed that Texas Air and Eastern would exclude all other potential purchasers from competing with the Texas Air offer.

87. On or about October 20, 1986, defendants caused a certain Notice of Special Meeting of Stockholders and a Proxy Statement-Prospectus dated October 15, 1986 together with a letter to Eastern's Common Stockholders from its President date October 14, 1986, Supplement No. 1 dated October 20, 1986 and a letter from

Merrill Lynch to Eastern's Florida Stockholders dated October 15, 1986 ("Proxy Materials") to be sent through the United States mails to Eastern's stockholders. The Proxy Materials were some 500 pages in length and solicited the stockholders' proxies to vote in favor of the Merger Agreement, Special Charter Amendments and Preferred Stock Amendments.

88. The Proxy Materials informed the stockholders that the favorable vote (by proxy or otherwise) of a majority of the outstanding shares of common stock was necessary to ratify the Merger Agreement and that Texas Air beneficially owned some 36.3 million of the shares of common stock, constituting 50.3% of the outstanding common stock. The said Proxy Materials further informed the stockholders that Eastern and Texas Air believe that stockholder approval of the Merger is assured.

89. By virtue of its extreme length, complexity of transactions and numerous matters submitted for stockholder vote, the Proxy Materials were intended to be beyond the understanding of the average Eastern stockholder, failed to highlight the most important facts to be considered by stockholders in deciding how to vote on the Merger proposal, and obfuscated the true nature of the transactions to be considered by the stockholders by scattering related information throughout the Proxy Materials, such as failing to state the dollar value of the inducement fee while disclosing the dollar value of the simultaneous payment by Texas Air when

discussing the sale of 10,935,000 shares of common stock pursuant to Section 9.1 of the Merger Agreement.

90. The Proxy Materials omitted to state at least the following material facts as required by law:

(a) Purchases of Eastern's common stock by Texas Air since Texas Air became an affiliate of Eastern on February 24, 1986 as required by Item 1(f) of Schedule 13E-3, of Rule 13e-3, including the amount of such securities purchased, the range of prices paid and the average price for each quarterly period.

(b) The approximate number of holders of record of each class of Eastern stock as of the most recent practicable date, as required by Item 1(b) of Schedule 13E-3 of Rule 13e-3.

(c) The source of the $108.7 million of funds of Texas Air to be used in the Merger if Eastern does not obtain sufficient consents from holders of Eastern's Debentures, as required by Item 6(a) of Schedule 13E-3 of Rule 13e-3.

(d) The excess of the liquidation value of Eastern's assets over their book value, highlighting the "off-balance sheet" assets.

(e) That the principal purpose for the Merger was to acquire Eastern for the advantage of Texas Air for much less than its true value, and to do so with Eastern's own borrowing power, cash flow and assets.

(f) That TWU, ALPA and IAM -- who through their various trusts were the largest stockholders of Eastern common stock -- had pre-emptive rights to purchase common stock and other equity-related securities when newly-issued shares were sold in violation of such rights to Texas Air pursuant to Section 9.1 of the Merger Agreement.

(g) That Bryan had delivered by messenger a certain letter dated February 7, 1986 from Bryan to Borman, the Chief Executive Officer of Eastern, pursuant to which Bryan suggested that Eastern allow employees to voluntarily convert debt of Eastern (approximately $50,000,000 of Investment Bonus Agreement funds) to newly issued Eastern common stock at the market price to increase stockholders equity and tangible net worth of Eastern.

(h) That a representative of Salomon Brothers, investment bankers retained by the outside directors, stated, at the February 23, 1986 meeting of Eastern's directors that Salomon's preliminary opinion was that a price of $10 per share "might be in the lower range of fairness".

(i) That the outside directors of Eastern refused to approve the Merger Agreement in light of the refusal of Salomon Brothers to express an opinion regarding the fairness of the offer to Eastern's stockholders at the February 23 Board meeting until Texas Air provided such directors with indemnification against liability arising from the Merger of $35 million, subject to a $5 million deductible.

(j) That Eastern's filing for protection under Chapter 11 of the Federal Bankruptcy Code was no longer an unavoidable alternative after two of the three unions agreed to the concessions sought by management, prior to approval of the Merger Agreement on February 24, 1986.

(k) That the meaning of the word "fair" as used in the Proxy Materials, meant something other than the best price that was obtainable for Eastern.

(l) That the way that defendants had structured the Merger effectively foreclosed any other purchasers from making a higher offer for Eastern or for Eastern's stock, and that defendants refused to consider and took active steps to discourage other offers.

(m) That the Lock-Up Option contained in Section 9.2 of the Merger Agreement is unenforceable under Delaware law.

(n) That the indemnification of Eastern's directors by Texas Air up to a maximum of $35,000,000, subject to a $5,000,000 deductible, in connection with the approval and implementation of the Merger Agreement, is unenforceable under the federal securities laws.

(o) That the No-Shop Provision contained in Section 6.5 of the Merger Agreement is unenforceable under Delaware law, and, therefore, the Board was obligated to seek alternative offers to purchase Eastern.

*

(p) The contingent liability of Texas Air due to the fact that Texas Air, in conjunction with Jet Capital Corporation and their wholly-owned subsidiaries, purchased and sold Eastern's common stock from January 22, 1986 to February 24, 1986 while in possession of material non-public information about Eastern.

(q) That certain events had occurred subsequent to distribution of the Proxy Materials, including the following:

(i) On November 10, 1986, Coalition Corp. submitted a written offer to the Board to acquire Eastern in a merger transaction pursuant to which common stockholders will receive $10.25 in cash for each share of common stock held by them;

(ii) On November 7, 1986, IAM filed suit against Eastern seeking specific performance and injunctive relief to enforce its contract granting pre-emptive stock rights to the WIP Trust. These rights are assertable with respect to the 10,935,000 shares of commom stock sold to Texas Air. The suit also seeks rescission of the Texas Air transaction.

91. The Proxy Materials untruthfully stated that at the February 23 meeting of the Board there were recesses to deliberate, when in fact there were merely several adjournments.

92. The Proxy Materials misleadingly stated that "it appeared to the Directors that, unless agreement could be reached with all three principal unions, default under Eastern's loan agreements was a certainty..." Any default would have only been technical and easily waived, as in fact occurred this time.

93. The Proxy Materials as in the past misled the Eastern's stockholders regarding the seriousness of the employees as an alternative purchaser (i) by referring to their coalition in quotation marks in Supplement No. 1 and the Proxy Materials (ii) by misquoting Bryan's oral offer of October 17, 1986 discussed in the Supplement No. 1 by changing his statement from the employees being "very" serious to "pretty" serious about the resolution and the proposals, and (iii) by omitting to state the history of the Employees' efforts to purchase Eastern and their purchases of Eastern stock, as more fully described, *inter alia* in paragraphs 43 - 45 herein.

94. All of the untrue statements referred to in paragraphs 91 through 93 were of material facts. Each of the facts alleged in paragraph 90 to have been omitted from the Proxy Materials was a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. The cumulative effect of such omissions and untruthful statements was to make the Proxy Materials pervasively misleading and deceptive.

95. Defendants acted with such reckless disregard for the truth that they failed or refused to ascertain and disclose such facts as would reveal the materially false and misleading nature of the statements made, although such facts were readily available to defendants. Said acts or omissions of defendants were committed wilfully or with reckless disregard for the truth. In addition, each defendant knew or recklessly disregarded that material facts were being misrepresented or omitted as described above.

Count II

(Brought by Plaintiffs Hastings-Murtagh, Murtagh, Bryan, Callahan and Schulte against the director defendants, defendants Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp. for breaches of fiduciary duties)

96. Plaintiffs reallege and repeat the allegations of paragraphs 1 through 84 above.

97. The action of Borman and the director defendants in entering into the Merger Agreement and precluding other potential offers was a breach of their fiduciary duty and the duty of care and loyalty, was grossly negligent, and was unauthorized under the Delaware General Corporation Law ("DGCL"), in at least the following respects:

(a) Eastern management failed to approach employee leaders who represented Eastern's largest shareholder regarding an employee purchase of Eastern;

(b) Defendant directors failed to obtain an up-to-date valuation based upon realistic and achievable assumptions and instead relied upon a dated valuation based upon assumptions which resulted in an unrealistically low valuation of the company;

(c) Defendant directors acceded to the condition of Texas Air that the merger be negotiated during a two-day weekend period, most of which had been consumed before the matter even came before the Board, which deadline was wholly artificial and a coercive device of Texas Air to enable it to purchase Eastern at less than fair value, and which led to the director's reliance on inadequate information regarding the intrinsic value of the company and the fairness of the transaction to Eastern shareholders;

(d) Defendant directors agreed to the Lock-Up Option and No-Shop Provisions demanded by Texas Air, which effectively precluded other bids which might have resulted in a higher price to Texas Air, including the bid which Eastern's employees consistently sought to make;

(e) Defendant directors have adhered to the No-Shop Provision in the face of knowledge that a bidder existed whose bid would be higher than the Texas Air bid, thus blatantly violating their obligation to obtain the highest price possible for the benefit of the shareholders;

98. Defendant directors breached their fiduciary duties to Eastern and its shareholders and improperly manipulated Eastern's corporate machinery by guaranteeing Texas Air the ability to acquire 51% of Eastern's outstanding common stock, sufficient to compel shareholder approval of the Merger Agreement without the affirmative vote of any non-Texas Air shareholders. By agreeing to and facilitating this improper lock-up of the proposed transaction, the defendant directors deprived Eastern shareholders of their fundamental right to approve or disapprove proposed business combinations involving Eastern and reduced the requirement of shareholder approval to a sham. Moreover, the defendant directors further breached their fiduciary duties to Eastern and its shareholders and manipulated Eastern's corporate machinery by arrogating solely to themselves the decision whether

to approve the proposed business combination of Eastern and Texas Air.

99. The defendant directors breached their duty of loyalty to Eastern and its shareholders by improperly accepting personal perquisites as an inducement to approve the Merger Agreement. The defendant directors finally approved the Merger Agreement only after Texas Air had agreed to indemnify the defendant directors for their breach of fiduciary duty in approving the agremeent.

100. The defendant directors further breached their duty of loyalty to Eastern and its shareholders by placing their loyalty to defendant Borman and Eastern management above their loyalty to Eastern and its shareholders. As admitted by Borman, the Merger Agreement was approved based on an "understanding" between Borman and Lorenzo that Borman and Eastern management would remain entrenched in their positions in control of Eastern following the merger.

101. Defendants Texas Air, TAC/EAL Acquisition Corp., and current directors Lorenzo and Bakes aided and abetted and conspired in the defendant directors' breaches of fiduciary duty by:

(i) Stampeding the defendant directors into a hasty and uninformed decision to approve the Texas Air merger

Agreement by imposing an artificial 48-hour deadline on acceptance of the proposed agreement;

(ii) Precluding the defendant directors from soliciting or approving other offers for Eastern which might provide adequate consideration to Eastern shareholders;

(iii) Insisting on a non-refundable $20 million "inducement fee" which could be used to purchase Eastern stock;

(iv) Importuning the defendant directors to accept blandishments, including personal indemnification and first class air privileges for life, to approve Texas Air's inadequate offer;

(v) Further inducing the defendant directors to breach their duty of loyalty by offering an "understanding" with Borman and Eastern management that they would remain entrenched in their positions in control of Eastern following the proposed merger; and

(vi) Requiring the defendant directors to manipulate Eastern's corporate machinery to lock-up Texas Air's proposed merger with Eastern and reduce shareholder approval to a sham.

102. By taking the above actions, Texas Air became an active participant in the defendant directors' breaches of fiduciary duty and knowingly reaped the benefits of those breaches of fiduciary duty.

Count III

(Brought by Plaintiffs Hastings-Murtagh, Murtagh, Bryan, Callahan and Schulte against the director defendants, Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp., for waste of corporate assets and gross negligence)

103. Plaintiffs reallege and repeat the allegations of paragraphs 1 through 84 above.

104. The payment by Eastern of golden parachute payments to officers, including some of the defendant directors, is without a proper or apparent corporate purpose, constitutes a waste of assets and is grossly negligent.

105. The payment by Eastern of a $20 million "inducement fee" to Texas Air to enter into the Merger Agreement is without a proper corporate purpose, constitutes a waste of assets and is grossly negligent.

106. The issuance to Texas Air of 10,935,000 shares of Eastern common stock for insufficient consideration is without a proper corporate purpose, constitutes a waste of assets and is grossly negligent. Although nominally requiring Texas Air to pay the sum of $6.25 per share for the stock, its real cost was only $1.30 per share, because the defendant directors agreed to pay Texas Air a $20 million "inducement fee" upon consummation of the stock purchase, and to finance $3.12 of the amount through a promissory note not due until 1991, thus providing Texas Air with Eastern funds with which to purchase the Eastern stock.

107. The sale by Eastern of certain gates and landing rights to Pan Am in order to obtain DOT approval of the Texas Air merger, which sale was made prior to consummation of the Merger Agreement and with the knowledge that there was another bidder prepared to offer a higher price for Eastern's stock whose bid the Board had a legal obligation to consider and whose acquisition of Eastern would not raise competitive concerns, is without a proper or apparent corporate purpose, constitutes a waste of assets and is grossly negligent.

108. Defendants Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp. aided and conspired in the wasteful and negligent acts of director defendants described above.

Count IV

(By Plaintiff Coalition Corp. against the director defendants, Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp.)

109. Plaintiff realleges and repeats the allegations of paragraphs 1 though 84 above.

110. Because of the defendants' actions as alleged in this complaint, and the specific violations of law alleged in Counts I-III, potential competing bidders, including Plaintiff Coalition Corp. and its shareholders, have been effectively prevented from bidding to acquire Eastern and obtaining good faith consideration of any such bid. The following actions of defendants, among other actions, have prevented such competing bids from being made and considered:

(a) the Board's agreement to the No-Shop Provision, its adherence to such provision and its failure to acknowledge the unenforceability of such provision;

(b) the Board's agreement to the Lock-Up Option and its sale of 10,935,000 common shares to Texas Air;

(c) the securities law violations detailed in Count I; and

(d) the Board's breaches of fiduciary duty and acts of waste and negligence as detailed in Counts II and III above, and the actions of Texas Air, Lorenzo, Bakes and TAC/EAL Acquisition Corp. in aiding and abetting such violations of laws.

111. Defendants' actions, unless enjoined, threaten to prevent effective consideration by the Eastern Board of Plaintiff Coalition Corp.'s offer for Eastern, which is manifestly superior to the terms of the Texas Air Merger Agreement.

Irreparable Harm And Controversy

112. Plaintiffs and all Eastern shareholders have been, and, absent this Court's relief, will continue to be, irreparably harmed by defendants' conduct in that:

(a) Eastern shareholders will be denied their fundamental right to approve or disapprove the Texas Air merger due to the defendants' manipulation of Eastern's corporate machinery;

(b) Other potential bidders, and especially Coalition Corp., are precluded from competing on a fair and equal basis for control of Eastern;

(c) Eastern shareholders are denied the opportunity to obtain adequate consideration for their shares; and

(d) Eastern shareholders will have inadequate information on which to base their vote on the Texas Air proposal.

113. Plaintiffs have no adequate remedy at law for the injuries threatened by defendants' unlawful conduct.

114. An actual controversy exists between plaintiffs and defendants.

WHEREFORE, plaintiffs respectfully demand judgment against defendants as follows:

(i) Ordering the resolicitation of stockholders of Eastern pursuant to a notice of meeting and proxy statement that complies in all material respects with Schedule 14A and Rule 14(a) and Schedule 13E-3 and Rule 13e-3 of the Securities Exchange Act of 1934;

(ii) Declaring that the No-Shop Provision is null, void, invalid and unenforceable;

(iii) Declaring that the Lock-Up Option granted to Texas Air is null, void, invalid and unenforceable;

(iv) Cancelling the $20 million "inducement fee" granted to Texas Air and imposing a constructive trust on any such fees paid to Texas Air for the benefit of Eastern and its shareholders;

(v) Preliminarily and permanently enjoining the defendant directors, Texas Air, TAC/EAL Acquisition Corp., their agents, employees, and anyone acting on their behalf or in concert with them from (a) performing under the Lock-Up Option, (b) taking any other steps whose purpose or effect is to hinder the ability of any third party to make an offer for Eastern; (c) voting the shares acquired from Eastern pursuant to the Merger Agreement and any other shares acquired by Texas Air or TAC/EAL Acquisition Corp. on or subsequent to February 24, 1986, in favor of the proposed merger; or (d) taking any steps to consummate the Merger Agreement;

(vi) Preliminarily and permanently enjoining Eastern, its directors, officers and agents from wasting the assets of Eastern, including paying any amounts due under "golden parachute" agreements, and the transferring of gates, landing rights, aircraft or other assets, except for fair value and except to parties other than Texas Air, TAC/EAL Acquisition Corp., or People Express, or any subsidiaries or affiliates thereof;

(vii) Declaring that the proposed Texas Air merger must be approved by the vote of at least 80% of the Eastern stock entitled to vote with respect thereto, and at least 50% of the shares not controlled by Texas Air;

(viii) Preliminarily enjoining Eastern, its directors, officers and agents from holding a special stockholders' meeting currently scheduled for November 25, 1986, until further order of court;

(ix) Ordering divestiture and rescission of any Eastern stock issued by Eastern pursuant to the Merger Agreement;

(x) Ordering the Eastern Board to in good faith consider the pending offer of Coalition Corp.;

(xi) Awarding plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees; and

(xii) Granting such other and further relief as this Court deems just and proper.

Elizabeth A. Hastings-Murtagh,
Daniel P. Murtagh, E.A.L.
Employees Coalition Acquisition
Corp., an Illinois corporation,
Charles E. Bryan, Robert V.
Callahan, and Larry Schulte

By: ______________________
One of their Attorneys

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(816/DD)

VERIFICATION

STATE OF FLORIDA)
) SS
COUNTY OF DADE)

CHARLES E. BYRAN states on oath that: I am one of the plaintiffs herein; . I have read the attached Verified Complaint for Declaratory and Injunctive Relief; and the factual matters alleged in such Complaint are true and correct to the best of my knowledge and belief.

Signed and sworn to before me
on November 10, 1986

Notary Public

Notary Public, State of Florida at Large
My Commission Expires Aug. 19, 1990
Bonded thru Maynard Bonding Agency

VERIFICATION

STATE OF FLORIDA)
) SS
COUNTY OF DADE)

ROBERT V. CALLAHAN states on oath that: I am one of the plaintiffs herein; I have read the attached Verified Complaint for Declaratory and Injunctive Relief; and the factual matters alleged in such Complaint are true and correct to the best of my knowledge, infomration and belief.

Robert V Callahan

Signed and sworn to before me
on November 10, 1986

Notary Public

Notary Public, State of Florida at Large
My Commission Expires Aug. 19, 1990
Bonded thru Maynard Bonding Agency

EXHIBIT C

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA
MIAMI DIVISION

ELIZABETH A. HASTINGS-MURTAGH,
etc., et al,

Plaintiffs,

vs.

TEXAS AIR CORPORATION, et al,

Defendants.

________________________________X

Case No. 86-2328
Civil-KING

November 21, 1986
9:00 a.m.
Miami, Florida

FILED BY
86 NOV 24 PM 5:47

TRANSCRIPT OF HEARING BEFORE THE HONORABLE
JAMES LAWRENCE KING

APPEARANCES: As noted in the record

Court Reporter: Elaine Somma
Official Court Reporter

- - - - -

(Call to the order of the Court 9:00 a.m.)

THE COURT: Counsel, we have scheduled for a hearing this morning in the matter of Elizabeth A. Hastings Murtagh vs Texas Air Corporation and others.

For the benefit of counsel I have read your briefs. I have scanned your exhibits.

I have not read those exhibits in detail but I am familiar with the exhibits. I have read your briefs.

All right, Mr. Tucker or Mr. Lowey.

MR. TUCKER: Mr. Stephen Lowey and F. Lee Bailey will handle the argument with the Court's permission. There is presently pending a motion pro hoc vice with no objection.

MR. LOWEY: Stephen Lowey from the firm of Lowey, Dannenberg and Knapp in New York. I appreciate the opportunity to address the court this morning.

Plaintiffs will take advantage of the opportunity presented to divide our time that has been allocated here.

We will make our opening argument for about one hour and reserve half an hour for rebuttal. Mr. Bailey and I will divide the argument.

The importance of this action is self evident and the consequences of this Court's decision on this motion will be far reaching.

Not only does this matter involve hundreds of millions of dollars, it involves the lives of forty thousand people, employees, twelve thousand of whom live in the Miami area.

THE COURT: This is deja vu. I had this in 1975 when Eastern Airlines and Gulf Oil Company were engaged in a tremendous financial struggle and Mr. Gambrell, the attorney for Eastern Airlines would rouse himself once a day to remind me that twelve thousand of the people lived in Miami and if I ruled against Eastern Airlines those people would be out of work.

The gentleman representing Gulf Oil Company, a man named Barefoot Sanders, now a United States District Judge, kept just getting me very upset over this each time I told him that irrespective of that.

But in any event, that was ten years ago. So now we are back to the same thing except you are perhaps two or three years away from your Federal District Judgeship if your are in the same position that now Judge Sanders was in.

Forgive the interruption. I didn't mean to interrupt your train of thought.

You are at the point that twelve thousand employees are vitally interested that live in Miami area are involved in the suit and forty thousand dollars system wide.

MR. LOWEY: That is true but these employees are not just employees. They are also as a group collectively the largest shareholders of Eastern Airline. At least they were until the events of February, 1986.

This matter involves not only their rights as employees, because that is not what this lawsuit is about.

It is their rights as shareholders and it is not only their rights as shareholders, it is the rights of all shareholders of Eastern Airlines.

Prior to the events of February 23rd, there were about fifty-one shares of stock of Eastern Airlines outstanding in public hands and approximately twenty to twenty-five percent of that was held by or for the benefit of Eastern Airlines employees.

But this case also involves an airline, a company, Eastern Airlines as a corporation; the company has had a proud history.

The airlines is a vital member of the South Florida community.

I wish I had had the opportunity to read a transcript of Judge Sanders argument before your Honor because I might well have learned from it.

I dare say the same type of argument that he might have made then is applicable here and that is there is a very real threat to the dismemberment of this ongoing entity.

Even if it is kept in corporate form, it will be dismembered. It will be like a skeleton of its former self.

It will not have the blood, the spirit, the working together enterprise that has characterized the ongoing operations certainly for the last few years since the 1983 labor agreements were reached.

Now, there have been here a history of labor management problems. There is a backround of that in this lawsuit.

But this is not really what the lawsuit is about. It is not to determine whether labor or management is right in the traditional collective bargaining sense.

It is a case involving corporate law. It a case involving the federal securities laws played off against a backround wherein none of the other cases you have an employee group that is the principal shareholder as a group. So, you have the labor side of it as well as the shareholder side of it.

Your Honor, make no mistake about this. If the preliminary injunction that we seek is not granted, the consequences will be disastrous for the employees, for the shareholders and for the airline as well as for the Miami area.

Now, I think it is important that I address myself first to tell you exactly what relief we do seek here today and then I will proceed to tell your Honor why this court sitting as a court of equity should grant us that relief.

In doing this, I shall address myself directly to each of the four questions that the Court has posed to counsel.

The relief that we seek today, your Honor, the relief that we seek prior to Tuesday morning 10:00 on November the 25th, is we seek a stay of that meeting for a sufficient time to enable the E.A.L. Coalition and its investment banker to do the following things.

We seek an opportunity to present the coalition's $11.50 per share cash offer to the Eastern's board of directors, and we also seek an order from this Court directing the Eastern board of directors to consider that offer in good faith and in the best interests of all shareholders.

This is something they have not done from the very first day that the idea of a possible employee owned airline was raised.

More specifically, in order for them to do that, we seek a preliminary injunction against implementation of the no-shop provision of the merger agreement, because the board has told us, told Mr. Bryan that we can't talk to you about this.

We have a contractual duty with Texas Air not to talk to you about your proposal and they have constantly pu-pu'd the reality of it, but they have also said even if it is real, we can't talk to you.

So, we do need your Honor an order to allow us the opportunity to make a presentation, a preliminary injunction against the no-shop provision. We seek what has been referred to your Honor in the cases in this area as a level playing field.

There are two competitive bids for this company right now today as there have been in the Adelman case, in the Anderson Clayton case, in the Revlon case that we have discussed with your Honor. This case is today precisely in that posture.

The courts in those cases and we seek your Honor to do the same thing, have recognized that when you have two competing bidders, you have to give them both an equal chance to make their bids and the board of directors has a duty to consider and to accept the best bid, the bid that it determines is best for all of the shareholders and bearing only that in mind. That is the only consideration that they are allowed to take once the company is up for auction.

Now, all the cases that talk about business judgment, that the board's business judgment is to be given a deference because the courts are not in the business of running corporations, all those cases, all those principles go by the boards in the context of a company that is for sale.

Eastern Airlines is presently for sale and has been for sale publicly we know since February 23rd. Actually we find out that secretly it was for sale back in December.

But there was no level playing field back in December. Mr. Lorenzo was given the inside track. He was given confidential company financial information. He had many conversations.

He had the opportunity to get an investment banker, Drexel Burnham, whose investment banker it is to line up junk bond financing in advance. He had a big head start. All this was done in secret.

When the time came when the proposed sale of Eastern Airlines to Texas Air was for the first time mentioned to its board members and Mr. Bryan and Mr. Callahan were board members and this was keep secret from them purposely obviously, for the first time it was mentioned on a Sunday at two o'clock to the board.

Mr. Bryan and Mr. Callahan had been advised the day before and I will pass the events of February 22nd for the time being.

But the point here is that the board as a whole only learned for the first time on February 23rd and by that time it was a done deal.

By that time there was an agreement on a lock-up option and lock-up shares.

Those words have become part of the jargon of this corporate take over field. But they express the reality of what happened in this midnight attack on Eastern Airlines and its employees.

This is like Pearl Harbor. They had absolutely no prior advance warning that this was going to happen in order to try to put into put together a competitive bid of any sort.

What the lock-up said--your Honor, there were two lock-ups.

Number one, ten million or 10.9 million shares were given to Mr. Lorenzo or Texas Air I should say.

They were issued. They were new shares, had not been in existence before. So instead of being 61.1 million, boom, there were 72 some odd million of which Texas Air was now given an 18 percent interest in the company.

What did it pay for it? It supposedly paid cash, and a note at six and a quarter or six fifty. But at the same time there was inducement fee.

So that at closing they exchanged checks so at the net of all those shares were issued at something like a dollar and a half.

THE COURT: What was the difference, 36 million from Texas Air to Eastern and 20 million back from Eastern, something in that range.

MR. LOWEY: Something in that range.

THE COURT: And that figure is about a dollar a share for the new shares.

MR. LOWEY: I think it is a dollar forty is what it turned out to be.

But that gave Texas Air a big position in the shares, about an eighteen and a half percent position which was just a little bit under -- nobody really has a precise idea of how much all the employees in the aggregate owed at the time.

THE COURT: Excuse me, and then I won't interrupt you again.

Does that include the five percent that Texas Air had already purchased.

MR. LOWEY: No, it does not include that.

Your Honor, by the way, interruptions are I find always helpful and I am glad your Honor identified that because that is an important point.

...They had already, because of the advantage of the inside information that they had from Mr. Borman in December that the company was for sale, standby we may be coming back to you, they had been in the market picking up shares in January.

This was not disclosed to the public. They did not file a 13D because they kept their purchases just under the five percent which would have required them to make public disclosures of those purchases.

THE COURT: Those purchases were made approximately in January of '86.

MR. LOWEY: Yes.

THE COURT: So that brought Texas Air's interst with the ten million nine that were made available to them by the defendants, that would have brought their interest up to approximately twenty three and a half percent or thereabouts roughly.

MR. LOWEY: That is correct, your Honor, as of that time.

In addition, because that is not enough to provide an iron clad lock-up, there was a second lock-up agreement and that was an option.

Eastern Airline's board approved the granting of an option to Texas Air to purchase another ten million shares, and at the same time or depending upon how Texas Air chose to do it, go into the market and buy in the market place enough shares to bring Texas Air up to the fifty-one percent level.

THE COURT: This was for the $7.50 price? They had an option to purchase ten million shares up to $7.50 cents a share.

MR. LOWEY: That's right your Honor. But the point is that this gave Texas Air a lot and there is nobody else as of the time that this agreement within just one day or less than one day, two o'clock in the afternoon until three o'clock the next morning--an agreement by the way wasn't even there two o'clock in the afternoon. It was still being drafted by the lawyers.

It wasn't really shown to the directors until sometime later on into the night, late evening if you will of February 23rd.

But the point of it is that the lock-ups were in place. The board did not, not only didn't consider any possible competitive offers from anybody not just the employees but from anybody, but they effectively closed the bidding, closed the auction; end of story, February 23rd.

Ever since that time, your Honor, the story of the answer if you will to the laches argument to the question that your Honor raised, was the coalition, were the employee shareholders guilty of laches, the answer to that and the story of what happened after February 23rd, is the story of efforts to try to overcome the obstacles, the practically insurmountable barriers to a competitive bid that the Eastern board put in place on February 23rd and have adhered to ever since then.

The efforts that have been made since that time, your Honor, have been sincere, have been serious frustrating attempts to do what seems to be the impossible.

The lock-up option and the no-shop provision got in the way at every turn.

Everytime Mr. Bryan wanted to come to the board and make some kind of an offer to get the board to consider an employee owned company as an alternative, because the board had justified and you will hear it today from counsel I am sure, justified its actions on the ground that there are only three alternatives.

The alternative was either to put the company in bankruptcy or to have an agreement among the three unions that was dictated by Mr. Borman, wage concessions by all three unions or to sell the company.

THE COURT: The sub-option piece meal sale. There were four options, selling the company piece meal.

MR. LOWEY: I don't believe that they actually considered that that night. You are quite right the option existed but I don't believe that that was one that was proposed.

THE COURT: Wasn't that discussed according to your briefs and correct me if there is any dispute over this.

When I am asking you these questions about factual matters, I am trying to assimilate what you have in these papers that you have filed here, you know, in the last few hours and I am really seeking information.

These are friendly questions. I am not trying to imply that I am one way or the other.

Was it presented and perhaps it was to the executive committee and not the full board, but sometime prior to the February 21st, 23rd time frame, four propositions.

One, the possibility of bankruptcy.

Two, concession from the employees, further concessions from the employees, wage concessions and other concessions.

Three, sale of the airline and a sub-heading or perhaps a forth option of piece meal of routes, planes landing slots and perhaps the last two or all intertwined.

But wasn't that presented by Mr. Borman to some group either the executive committee or the board. Help me out on that.

MR. LOWEY: Your Honor, there is a lot that happened on the February 23rd meeting.

Merrill Lynch did present an analysis, a study. They certainly did have an analysis of the sort that your Honor referred to.

That existed. There is no question about it. That has been studied that has been looked at.

I do not believe and I can be wrong on this and if I am wrong I appreciate somebody correcting me, but it is my reading of the minutes, my understanding of the total situation that the issues before the board on February 23rd, did not include a dismemberment of Eastern, even though that had been anaylzed.

But there was a forth issue that the board could have considered that Mr. Bryan asked it to consider on February 23rd and which it refused to consider.

And that is to give the employees a chance on their own to make the necessary concessions.

There is not an issue here of an obvert union fighting a fiscally prudent management that had to deal with banks and the banks are demanding fiscal responsibilities that the unions refuse to knowledge and knuckle into.

That is the picture that Eastern Airlines and its attorneys would want to present to this Court. But that isn't the reality here.

The reality here is that these unions knew what the situation was. They knew about the financial troubles.

Back in '83 it was, and when I say unions, I really do not just mean unions, and I misspoke when I say that, because it is all the employees. There are a large number of non-union employees that did the same thing as the union employees did.

And that is to make across the board concessions and they responded to the threats of bankruptcy speeches, the reality, and they kept Eastern Airlines alive with their own concessions to take substantial pay cuts.

But they got something in exchange. They wanted a voice in the ownership. They wanted a piece in the ownership and a voice in the management.

That is why, your Honor, when we come up to February 23rd, we are not dealing with a confrontational situation necessarily.

We are dealing with efforts by the employee representatives to work together cooperatively and those efforts were turned aside. There was deliberate efforts to turn those aside.

So when Mr. Bryan on February 23rd offered concessions, he did so conditionally. It is painted here as if the machinists with obvert. That is is not so.

Those concessions would have been there conditionally upon the resignation of the withdrawal of Mr. Borman. That was a condition.

But that is an option, you see, that was not considered by the board.

But why wasn't it considered by the board? Because they didn't want to embarrass Mr. Borman. Mr. Borman they respected. They cared about him. He was one of their's and they protected him.

But in chosing the option that they choose, namely the sale of the airline to Texas Air, they did not protect the shareholders and I am talking about all the shareholders because this is a lousy deal for all the shareholders, certainly when compared to the coalition's bid which I will come to in a moment.

But to pick up on this laches point that your Honor has asked counsel to cover, Mr. Bryan was in a chicken and egg problem because of that no-shop and lock-up provision.

And I shouldn't just say Mr. Bryan because he has the affidavit here. But we are talking about really the three unions, the leaders of the union, the pilots

organization, the flight attendants organization as well as the machinists organization.

THE COURT: Excuse me, the transport workers, I thought there were four entities.

MR. LOWEY: The forth is the non-union employees. They are transport, the I.A.M, A.L.P.A and the non-union employees.

THE COURT: Which group are the flight attendants, which are they part of.

MR. LOWEY: T.W.U..

THE COURT: That's the transport.

MR. LOWEY: Yes.

THE COURT: Okay, I understand.

MR. LOWEY: There were efforts made by both the pilots organization and the machinists to explore what could be done to put together financing for an employee owned airlines and they were met at every turn by the following problem.

The financier says, "look you give us the wage concessions or you give yourself the wage concessions." because everybody knew that additional employees concessions were needed. Everybody recognized that.

The employees would be willing. The attitude they took was we are willing to work for our own airlines. We will work for nothing, but for your airline Texas Air, we are not going to get rip-offed by your, bank but for ourselves we will do it.

So when the alternative was clear to them that for employees as stockholders and as employees, the Texas Air option, it was one that was an impossible thing for their livelihoods for their community.

They went to try to get financing and they were told, "look if you make the effort that you say that you say you are going to make, the sacrifices that you are willing to make and save the labor cost that you are willing to do, this deal is financeable. No problem. The money is there. Certainly the financing is available to you as it is to Texas Air with its very highly leveraged debt ridden organization."

Texas Air is certainly no model of financial stability, barely holding itself out of insolvency on a balance sheet basis.

So why shouldn't the employees have gotten as a group the necessary financing. The answer is because of the lock-up and the no-shop.

So the employees went to the lawyers and said if we can get this lock-up and no-shop clauses knocked out, then we can get the financing.

The lawyers said, "Wait a minute. As we interpret the decisions of the courts, these decisions that go to the question of a competitive bidding for a corporation that is for sale, until you have a competitive bid to make, you can't ask a court to issue an injunction against a proposed transaction. You can't fight something real with nothing. So you have to come back and tell the court about your alternative."

Then the court under applicable law must find if, I shouldn't say must find, but certainly can reasonably be expected to follow those decisions, those cases which clearly and we are talking about Delaware law which is applicable and the Delaware Supreme Court is the court that sets the rules for the purposes of the corporation law for Eastern Airlines.

The Revlon case is a controlling case under Delaware law. The point of that is that there were two competing offers.

So you can't come into a judge and say, "Judge, stop this terrible no-shop lock-up. Stop this terrible merger," if you don't have anything to present that is better than it.

So that is the bind. And it has taken that time. There have been sincere ongoing efforts to get financing. There has been sincere--and it has taken this much time.

In these other take-over cases when you are talking about Hanson Trust fighting Merrill Lynch for controlling of FCM, Hanson Trust already has it and this a multi-billion dollars organization. Financing is not a problem, when you are talking about a take over specialist like Asher Adelman making a play for Freuhauf and Merril Lynch on the other side of that one.

Again they get their financing together in an instant because they are dealing with one person, one entity with an enormous magnitute of capital immediately available.

But when your dealing with employees, forty thousand employees and their representatives, it is not so easy to raise the money right away and the money is going to come out of their sweat.

So the point is there is more time needed than in these other cases. You can't do what they call a Saturday night special.

THE COURT: Does your research of these cases given an even playing field I think as you described it, would that indicate that a court in considering the validity of these clauses in a contract, can take what develops as competing offers at a later date. I am not phrasing this well.

My question is what is the law with respect to a situation where at least it appears that here the competing offer came after the original offer by Texas

Air.

The other cases that you cited or some of the cases that I had a brief opportunity to look at, seem to indicate if there are two competing offers on the date that the board of directors or the executive committees enter into these lock-up clauses and these no-shop clauses, that the Court then will say no, keep a balance playing field.

Here is it, number one, your position that legally an offer may come along later which then the Court should balance the playing field or and/ or perhaps is it your position that the offer was always there but it just developed to its finite position here this morning or yesterday I believe when you filed this latest or one of your pleadings yesterday.

You may have two positions. I am not trying to force you into one or the other. I need whatever help you can give me from the benefit of your research.

MR. LOWEY: I understand your Honor's question. It is an important question and my answer is the former is our response.

THE COURT: I can't remember which I asked. I am confused by my own question.

MR. LOWEY: The board of directors has a duty to the shareholders to consider what is best for the shareholders at all times.

THE COURT: At any time.

MR. LOWEY: The contract that it entered into back in February doesn't permit them to walk away and say we did our best on February 23rd and close our eyes to everything after that for a lot of reasons.

Number one, the investment bankers fairness opinion. After all the directors relied upon investment bankers. They hired Salomon. Salomon on February 23rd refused to give them a fairness opinion. They refused to say that the Texas Air merger proposal was fair to the shareholders.

Salomon said, "I can't tell you that." and the directors said, "if you can't tell us that, how can we approve it?" Mr. Lorenzo had an answer for that.

THE COURT: Thrity five million.

MR. LOWEY: Sure, not to worry. You are indemnified.

THE COURT: Is he good for it?

MR. LOWEY: The point is this. The answer to your Honor's question, in the Adelman case, Adelman against Freuhauf, the situation was precisely the same with respect to the board of directors' action.

The directors had already approved a management buy out proposal and a tender offer was actually ongoing for management.

The Federal Court in Michigan issued a preliminary injunction against the consummation of that tender offer which would have been the end of the game, completely, just as Tuesday is the end of the game here, issued an injunction, even though the Adelman offer came a along afterwards.

And it said and there is a specific order to this effect in the Sixth Circuit, and we have the Sixth Circuit opinion that directed the board of directors to go back an reconsider it. It is a specific direction.

The direction that I asked your Honor to give here is modeled on the Sixth Circuit ruling in Freuhauf.

"Your duties continue and we direct you to go back and consider in good faith this proposal."

Now, your Honor, I haven't covered as yet the details of the proposal. You about the viability of the proposal. That's mostly an evidentiary matter. We are not asking this court today--

THE COURT: I am sorry I didn't mean to get into --Well, mainly what I was concerned about today is it the plaintiffs position that on February 23rd through the efforts of Mr. Bryan that had been frustrated according to your submission, is it your position that there was in fact a second alternative to the Texas Air bid and or collatoral to that, even if it were not to be construed as being two people, two entities two groups bidding.

Was it or is it your position legally that the court may now eight months after the fact consider competing bids and try to balance the playing field.

You have answered the second prase of it very adequately relying on the Freuhauf opinion and the first one I am not sure.

MR. LOWEY: The first one, we do not take the position that what was proposed by Mr. Bryan on February the 23rd was the equivalent of an offer that is in place today or even the beginnings of it.

Because that is not what was going on at that time. Other alternatives were being explored.

The idea of an employee owned or competitive bid if you will, didn't come back until afterwards because the idea of employee owned airline has been there and in fact the employees felt like they owned the airline.

They were proud of their ownership. They were the largest shareholders as a group. But they didn't see the need to get one hundred percent or fifty-one percent because that was not an issue.

Only when the Texas Air offer was sprung at the last minute, did the need then arise to come up with some financing to make a counter offer.

So we don't take the position as of February 23rd it was on the table.

THE COURT: All right.

MR. LOWEY: I will reserve time to address some of the other issues and there are other things and Mr. Bailey and I agreed that we will divide.

Mr. Bailey has a number of things that he wishes to bring to the Court's attention.

So I will at this time turn the podium over to Mr. Bailey and reserve time at the conclusion of the defendants presentation to make some additional points.

And also, your Honor, you really don't have to apologize for asking questions to me because they are very helpful and certainly we appreciate the fact that there is a big stack of papers on your Honor's desk.

Your Honor had been trying cases around the clock. There is a limited time that your Honor has to consider these matters and it is a matter of vital importance.

And so the extent that we can be of help, that's what we are here for. I hope the court would feel whatever time it would take this morning if there are any questions, I would be happy to do my best to answer them.

THE COURT: I want to say because we got started a little late, we would add ten minutes or so to both sides. I am trying to be very fair.

I might say digressing totally that this is probably the one opportunity that you have in your life to Mr. Bailey quiet. Never again will you be in such a position because nobody can keep Mr. Bailey quiet.

I'm sorry. That's totally irrelevant. Mr. Bailey, we will be delighted to hear from you.

MR. BAILEY: I would like to ask the court's indulgence on a point.

It appears that my partner Richard Gerstein conspired to design these podiums, he being 6'6" and the only one that can use them.

Maybe the Courts did it to blunt the assaults and contortions of counsel making argument.

But in any event I would like to stand to one side if I may.

THE COURT: Wander any place you wish.

MR. BAILEY: It appears that every ten years Eastern Airlines will be assaulted from Texas and I express the hope that you and I will again meet under these circumstances and Eastern will still be here.

THE COURT: And both of us.

MR. BAILEY: Exactly. If it please the court, I believe that the case before you which without indulging in fancy rhetoric is literally capital.

This is the life or death of Eastern Airlines today in this District Court.

It requires a little bit of overview as to how we got here and I am well aware that your Honor is no stranger to the airlines industry. We both married into it.

I speak as one who in 1952 had its first airplane ride in Eastern's constellation to come to Florida and fly in Pensacola.

I was there with the employees for most of the turmoil that occurred in February, including the blind sighted attack to which no competing offer ever could have been made.

How did Eastern get in that position? The papers of Eastern say it is only because the employees were being overpaid.

But your Honor in order to track this forward and see where the fault may really lie I am going to start in 1973.

In 1973 there were about six major trunk carriers all pretty healthy, Eastern, American, United, Northwest Delta and then but no longer Pam Am.

Mr. Higginbottom then the president, chief operating officer, the fellow that really ran the airline, brought them from New York to Miami for the greater good of all.

In 1973 the price of fuel went through the roof and a recession came to America. Either of those things spells big trouble for highly cash volatile discretionary income business of airlines operations.

And as many publication have shown, because airlines have been analyzed and reviewed in the trade journals, Time, Newsweek, Businessweek, U.S. News and World Report, constantly during the last twelve months as upheavals seemed finally to be settled, the major trunks through their wisdom saw the problem coming.

From a pilots point of view, the first rule of flying is stay ahead of the airplane. It is a wonderful instrumentality, get behind it and it will kill you. If you stay just even with it, a moment later you will be behind it.

So in the industry it was necessary to forecast what the needs would be in all of the trunks and Mr. Higginbottom said, "Pull in the belt, pile up the cash. We are going to hurt on two fronts and we need to get through."

When his memorandum to the board was ignored, he left the company and went to Rolls Royce from which he retired a month ago.

The management of Eastern went on a different

course. They indebted themselves, bought new equipment, spent money and then another crisis came, ill advised in its execution at least, but a crisis for every structured trunk.

Vital to the understanding of this lawsit is the profile of an airline employee, particularly the operating employees represented by the unions in this litigation. This is a strictly vertical employment opportunity.

The nearest analogy I can find is the military. You chose it as career. You start low at modest pay and as you pile up year after year and hour after hour of experience number one, and seniority number two, you come to make a decent wage and you are unemployable either in your industry or generally in other industries if you lose that slot.

Pilots in particular insure themselves heavily for disability because one coronary and they have nowhere to go. We continue to function.

The FAA not only says you are out but if they hit the age of 60 where I think we begin to really come into our own, they are all through.

So, all of these trunks lived in that structure, in a regulated atmosphere which although there was competition, it was kind of a cost plus operation.

The Government would allow you a profit, if you ran your airline well. If you didn't, you got into trouble.

Now deregulation came. Pushed by the giant which through its muscle to allow it to survive, the devil take high most and that was United. Richard Ferris lobbied, Alfred Kahn and Jimmy Carter and they deregulated the airlines an everybody knew what would happen.

The best analogy I could give you is if somehow somebody had the idiotic notion that we would deregulate the federal bench and we were suddenly with people twenty-eight year old distinguished Federal Judges. We would survive but it would certainly rub luster from our jurisprudence.

THE COURT: Poor example. Some of our best judges are our newest ones. I have to defend them. But they are not twenty-eight years old.

MR. BAILEY: Everybody knew that we are training at eighteen, nineteen and twenty to fly, that the four stripes in an airline career was a goal that every pilot thought of, myself also coming out of the military.

So we have youngsters who were perfectly capable of operating an aircraft that didn't have the tens of thousands of hours of almost mistakes that makes pilots close to flawless by the time they sit in that seat.

But they could fly an airplane and there was tremendous pressure on the bottom of the pilot hiring group.

Indeed a company went into business just to inform a candidate where they might get a job and what the picture was.

With deregulation, lots of cheap airlines on the market, very low fixed costs in operating, they began to spring up, Peoples Express, Air florida was an example.

And they could go into business for very little money and by attacking seventy-eight percent of the controlable cost of airline operation, the fact that fifty-five year old people with children in college were getting a wage that would permit them to send them to college, they could hire the thirty year and the money be damned and operate the airline.

They could hire flight attendants that hadn't been able to find work at major trunks because they were waiting in line and machinists who are also very high trained people.

Some thought this is the end of the trunk carrier, the cheapo airlines is the thing of the future. The purchaser of this airline is of that ill.

Now is appears as his protegee who thought peoples had fallen and most of the start-ups have fallen. And the trunks through good management have gotten through and the policies of this administration are saying through an open merger policy, long may the trunks live.

The decision made here today will decide one of three things.

Either Eastern Airlines whose employees are going to pay for its stock whether Mr. Lorenzo gets it or they get it. They will pay any way, whether Eastern Airlines remains in the position of a distinguished venerable trunk carrier with experienced people who earned the right to where they are and have nowhere else to go.

Or, whether it will descend into that temporary morass being assembled now almost solely by Texas Air.

The last days of the cheapo, Peoples Express, New York Air, Texas Air and Continental with the union busted, $32,00 a year captain profile, $29,000 at Peoples Express. Law clerks and secretarys are worth as much and the $100,000 the trunks are paying the pilots, Mr. Lorenzo finds his way around.

You have very little jurisprudential guidance to decide this case for one reason. Something unique happened here. The board of directors abandoned and set itself up in adversity to its principal shareholders.

I suggest to your Honor that the questions about offers on the 23rd of February should be answered two ways.

Number one, the circumstances were structured and orchestrated to make a formal offer impossible.

And number two, the defendants are estopped because of what they have done to raise the issue.

These plaintiffs, plaintiff shareholders and the board could not possibly see through the union smoke to realize that they were fiduciaries to the people who were shareholders first and unions second.

They were being barraged in the press that Eastern alone came into deregulation with so much debt that the cheaper airlines killed them and the debt escalated to approximately five times that carried by the airline that started in almost exactly the same spot in 1973, same money, same routes same equipment, American.

They had five times the debt. They couldn't charge anymore. They were competing heavily with the low cost and they said,"Gentlemen we can't manage any better than we are doing, you must pay."

So Eastern employees put in nine hundred million over a period of years in concessions. Eastern pulled a left handed Aesop.

I don't denigrate that term because I am left handed but without going through all the formalities they say you are paying X dollars to us, we will give shares.

So now the employees come back and say, "Here we are again. Your very good management took all the money we gave you and fretted it away. It happens every year. Now you want more cuts from our pockets into your banks which you will fret away. Could we have at least some stock."

As the papers show they say, "No, no we can't dilute the stock any further, that will be impossible" not telling that that a plan was afoot that wasn't hatched until February to give eleven million shares for a bean compared with the twelve million of sweat equity and huge dollars that these people had.

The option the board expressly discouraged was the most viable option of all.

Give us the cuts we need to pay off the debts that we created because the other airlines paid their employees on scale or more than Eastern and somehow managed to keep their debt from escalating. Eastern couldn't do it.

Then a significant thing happened. First of all we are told very little and for good reason because I think it would read like some of the conspiracies your Honor tries on a regular basis about the meeting between Mr. Borman and Lorenzo.

The board very much like my position on capital punishment, I am utterly opposed to it except for people who shoot me and then in favor.

They said what do we fear most? An attack on the board, the press. If the employees get too much stock, that can be control and if the employees get control, we could be kicked out. And if we get kicked out, aside from it being ignominious, we could be sued, sued, sued, the most frightening word in America.

Their objective was to stifle the employees to keep them off balance to keep them uninformed, to not tell the truth and to hammer out the steel with Lorenzo.

And the papers drawing of the inference with your experience as a lawyer and judge would certainly make easy and which the evidence would show overwhelmingly if we were permitted to adduce the following happened.

An F. Lee Bailey solicitation was made. Often people say, "Mr. Bailey would you write a letter for me for $5,000. When they hear you have come into the case they will settle."

Mr. Borman started talking to Mr Lorenzo and said what will you charge for me to use your name because if I tell the employees we will bring Frank Lorenzo in, because you've busted everybody, I think we can knucle them under and that's worth something.

He, Frank, said, "Okay, twenty million dollars. Now, if you fail, if they call your bluff, the other side has to be I will give you back the twenty million and a few beans and you give me enough shares so that in addition to what I will buy on the open market,five percent, I will be even and then we will a merger.

So they will either buy the airline from me or they will give it back to you." There is no question that happened.

There is no question that while all the unions were in turmoil on the 23rd, the pilots had the strike vote ready to go, the flight attendants March 5th and if the pilots struck, well the flight attendants wouldn't mean much.

One by one they called in and said concede or Lorenzo, and down they went to save Eastern. But Mr. Bryan put a condition on it.

He said, "We will concede. We will give you what you need, but not for you people to throw way again. Put in responsible management that can do what the others do, manage a good airline because we are giving you an edge to off set the terrible burden that you carried that your competitors don't".

No way. So when D day came down, not only was no offer possible, not only had the outside directors and the inside directors abandoned and stifled these shareholders rights, your Honor, whose equities in this case are doubled.

They are not just investors although they enjoy that status and every right that shareholders enjoy, but they are at a cross roads because, your Honor, you are quite right, dismemberment of the airline was discussed.

These people have always negotiated with the hammer of bankruptcy over their head and this time added to that was bankruptcy or Lorenzo. Take one of those grizzly choices.

If this injunction is not granted, the following will happen and I predict it, so if we should meet ten years from now and there is no Eastern for Texans to assault, we can at least do an I told you so.

Mr. Lorenzo if he buys this airline, just look at the papers, cannot possibly run it as a trunk carrier. He can only run it by cutting these people as employees to a very low wage, by dragging them back through the ages to compete with thirty year olds who can live on what they are paid.

But when those people get to be fifty-five the scales will be back up again. This a temporary window caused by deregulation. These people will be gone. They have nowhere to go.

He wil sell the Eastern Shuttle to one fellow, the reservation system to another fellow, repaint the airplanes, take them to Continental, take the young pilots, get rid of the senior pilots and flight attendants and machinists where he can and Eastern will disappear forever, but the the remnants in part will be found in Houston where they don't have the good weather we have but they have a lot worse, and an even more he grizzly choice will confront the current employees.

So I suggest that the equities viewed realistically and in the context of airline operations and what these directors did to these stockholders, very plainly suggests that a short delay to answer only one question to your Honor and I think the answer is before you, the employees have the power to give five hundred million dollars a year of new money to this sick airline in order to make it well and are willing to do so.

They have the investment banking people who can get loans predicated on that very sum of credit quite in contradiction to the affidavit that was hurled at us at nine o'clock this morning and we have an invertment banker here this morning who is willing to say without question that is so.

And they have one other thing. They have the best manager and the last good one that Eastern ever had seated right here ready to pick up the helm working in an unprecedented way with all of the professionals.

And I say partaking of both professions, the most professional, disciplined in this country.

We do continuing legal education occasionally. They have to prove every six months that they are still worthy of the trust that two hundred or more people place in them when they board their airplane and they are vertically trapped.

What will Mr. Lorenzo suffer if you give the court a chance to take a better look at the realities? Very little.

What will the shareholders suffer? Not much. If Mr. Lorenzo walks away, that eleven fifty offer is good and long before he has the right to, you will have an opportunity to know.

We just need a little time. If you rather have facts than rhetoric of the things that are not self evident, we could talk to a witness or two.

Personally I would like to chat with Mr. Lorenzo under the benefit of an oath. But that will be up to the Court.

What I suggest, that the worst harm that you can do to the real party in interest, Texas Air, if you grant the injunction and the employees should prevail on the merits, is to put one hundred eighty million dollars in his pocket and that isn't a bad sentence to hand to the loser, your Honor, according to the sentencing guidelines. I thank you.

THE COURT: All right.

MR. HALE: If I could, John Hale and Fran Annanis for the outside directors and I would like to introduce to the Court Mr. Lewis Kaiden and Mr. Chris Menstram (phonetic) and respectfully move their admission for the purpose of this case.

THE COURT: All right.

THE COURT: Any objection to at this time.

MR. LOWEY: No objection.

THE COURT: Fine, motion granted, Mr. Hale. This is Mr. Ross, I believe.

MR. ROSS: Yes, Your Honor, David Ross and I appear on behalf of Eastern Airlines, on behalf of Texas Airlines and on behalf of all those members of the board of directors of Eastern who have been served with this lawsuit who are associated at ay time with the management of Eastern.

Mr. Kaden appears here today on behalf of the outside directors of Eastern Airlines.

I too would like to introduce the court Mr. Paul Welsh of the firm of Morris, Nichols, Arsht & Tunnell who appears of counsel to Texas Airlines and I too would move his admission to appear in this case.

THE COURT: Any objection.

MR. LOWEY: No objection.

THE COURT: Thank you. You are welcome, Mr. Welsh.

MR. ROSS: Your Honor, as I listened to Mr. Lowey I knew that it was going to be necessary for me to stand up and talk a great deal about reality because reality is what this case is about and reality is what the plaintiffs today and yesterday and in June and July and in February and indeed before February is what the plaintiffs have continued to ignore at Eastern Airlines.

But when I heard Mr. Bailey talk with his customary eloquence that I hope unusual irrelevance, I knew that we had gone beyond the question of reality and that Mr. Bailey like that other so eloquent master of ceromonies that we all remembered had taken us indeed into the twilight zone.

It appears that Mr. Bailey may well be the man the unions wish to have run this airline for we heard a great deal about is capabilities.

But the issue before this court contrary to what Mr. Bailey has to say, has absolutely nothing to do with who this court believes should run Eastern Airlines.

For there is one proposition of law that is so fundamental yet so ignored by the plaintiffs argument in this case that it bears repeating.

It is not for this court to decide whose offer is better even if there were two offers. It is not for this court to decide whether or not the board of directors should take some vague, unstated proposal of the plaintiffs or listen to it.

It is for the board of directors of Eastern Airlines to make those decisions.

They are the people who by law have been elected by the shareholders of Eastern to make those decisions and this courts power under the business judgment rule which Mr. Lowey wishes to throw out the window, is merely to review whether the board of directors in February of 1986 acted in a way that was in the best interests of the shareholders and not in their own self interest and acted in a way that was not grossly negligent.

Once that is true, this courts inquiry ends.

THE COURT: Well, now should I do that this morning or, you know, tonight at midnight or tomorrow night at midnight or some night at midnight?

Should I do that now on the basis of these well written briefs and the pleadings the very fine pleadings that you excellent lawyers have carefully prepared or would a decision like that, that is whether or not the board of directors of Eastern Airlines in February of 1986 acted prudently and properly and exercised their best judgment in a fair and reasonable manner.

Should that be done at the conclusion of the taking of testimony on the application for preliminary injunction as suggested by Mr. Lowey and Mr. Bailey.

MR. LOWEY: That is indeed what Mr. Lowey and Mr. Bailey would like because they want up to stop this action.

THE COURT: I understand that, but let me ask you this.

You started off saying that that was what I would be deciding, that is did the board act reasonably and I submit to you as perhaps not a question but more of a statement, that that's asking the court to do the impossible given the timeframe of this litigation.

MR. ROSS: It maybe but who is responsible for that.

THE COURT: But isn't the issue or is the issue not what you have suggested in your opening remarks as being whether or not the board acted prudently under the business judgment rule, but is it not perhaps whether or not this matter is presented or comes to the court in such a situation as to make it impossible or possible to grant injunctive relief or withhold injunctive relief.

But more importantly, whether a delay to permit the taking of some testimony will cause such irreparable injury to the defendants at least to the defendant Texas Air Corporation so as to outweigh the harm that Mr. Lowey and Mr. Bailey outline as that which will flow to the plaintiffs.

I am wondering if the issue that you present to me to solve in a few hours is much broader than that which I thought you folks were asking me to do.

MR. ROSS: I could not agree more, because when your Honor examines the evidence you will find, A, absolutely no irreparable harm to the plaintiffs in this case, B, an unbelievable irreparable harm to the defendants in this case and to the public interest.

And the only reason that your Honor has been put in a position by the plaintiffs to be asked at this late date to make that kind of decision which goes only to the last element, a substantial likelihood of success on the merits in this case, is because the plaintiffs have been guilty of laches and that is precisely what I wish to address today.

Your Honor, I was amazed to see the uncharacteristic candor of plaintiffs in their own affidavits filed yesterday in this case.

We said in our brief that this was an eleventh hour attack on this merger.

Indeed the plaintiffs went me one better because each of the plaintiffs in their affidavits filed yesterday admitted it was indeed past the eleventh hour when they attacked this merger.

And it is and I submit it is about 11:58 and at that last minute avoiding the reality of the situation and what is going to occur next week, the plaintiffs ask you to make that tremendously difficult factual determination they claim, but a factual determination that we think is pretty simple because it is so clear, that the board of directors of Eastern was grossly negligent and therefore you ought to stop it and throw it out.

So let's address the issues that the Court addressed to us today, the irreparable and the balance of harm and the laches argument.

Your Honor asked one of the questions to be addressed today, was there an offer today and was there an offer back then in February of 1986.

There are two simple answers to that question, but they have a different basis.

One is a factual answer. Is there an offer today. The answer to that is very simple factually. The answer is no, there is not as we stand here today an offer on the table from the plaintiffs that could be considered by Eastern Airlines.

But the more important answer to that question and this is where we got into the twilight zone because it is totally irrelevant whether there is an offer on the table today, because the law is not as stated by Mr. Lowey that a board of directors has the obligation to breach a binding contract to except an offer that comes up at 11:53.

Were that to be true, your Honor, there would never be an end to this process because if another offer came tomorrow and another offer came the day after that, you could never have a contract that closed. There would always be somebody standing on the steps saying that I got another offer.

But the law is and I won't belabor it because it is set forth in detail in our briefs, is that the board of directors simply had to exercise their judgment on the facts as they existed in February of 1986.

Were we to breach a binding merger agreement with Texas Air at the instigation of the unions, I would suggest your Honor that we would see Texaco vs Pennzoil all over again.

What could be more direct tortious interference with a contract that was held in the Jewel vs Pailus (phonetic) case cited in our brief, for someone to bust up a binding merger agreement.

And that is the reality that the unions seek to ignore. There is no playing field to open up here.

There may have been in the union's view a playing field in February, but today there is not, and you can not create one where none exists.

What we have is a binding merger contract

THE COURT: Let me interrupt you one second. There is a gentleman that does art work for news reporters and you are out there trying to see his face. Why don't you just step over here an have a seat and make your life a little simplier if you can.

I am sorry to interrupt you and all but Mr. Hughes is so quiet about the way he works around this courthouse and has for years.

He doesn't interrupt folks so he is welcome, but I didn't want him trying to stand if the hallway and get Mr. Lowey's profile. Mr. Bailey's profile would be all right, maybe even better.

I am sorry I interrupted you but I have a little compassion for a working fellow that has to earn a living.

Don't do mine, do his. These folks think that I let you in just to do mine.

Go ahead, sir.

MR. ROSS: The reality that the plaintiffs ignore is that we have this contract and that this contract has been submitted to no fewer than four independent respected investment banking firms including two, your Honor, selected by the I.A.M. and T.W.U with its own stock employee trustee, the gentleman who controls the very stock that the plaintiffs keep talking about.

Every single one of those four investment bankers, including their own, has opined in writing that the Texas Air proposal and merger agreement is fair to the shareholders of Eastern Airlines. Not one person, not one investment banker not one witness in this case has said that it is not.

THE COURT: Am I to judge that in this hearing today.

MR. ROSS: No.

THE COURT: That's my problem.

MR. ROSS: And that's the problem with the plaintiffs case. You are not supposed to judge that. They want you to judge that.

They stand up here and they want you to hear this eloquent statement that they have a better offer for the shareholders of Eastern airlines.

But you, your Honor, are not supposed to judge that. They would have you believe that you are. That is the fundamental principal of the business judgment rule.

It is of the board of directors of Eastern who makes that judgment.

And as Judge Aronovitz said so to the point in the Equity Group Holdings vs D.A.G. case cited in our brief, it not for this court to substitute its judgment for the board of directors of Eastern and to force Eastern Airlines to enter into an agreement that the parties themselves did not negotiate.

That is the fundamental law in plaintiffs entire position.

They should have not be here before your Honor arguing that their offer is better and they need time and they want to get an investment banker because this court doesn't make that decision.

What has occurred, your Honor, the issue is, was there something in February of which the plaintiffs should have complained, and if there was, where were they?

Why have they waited since February of 1986 to come before this Court and raise issues that could have been raised in February, in March, in April, in May and in June before Texas Air and Eastern Airlines irrevocably changed their position in reliance upon a binding merger contract that cannot now be undone.

The plaintiffs, when you listen to the relief they ask for, want you to order Texas Air to give up the 10.9 million shares of stock that they bought from Eastern

Airlines.

Even if this court had the power to do that which we submit it does not, what is the reality of the situation that plaintiffs ignore?

If you took aware way that ten million shares of Texas Air stock, Texas Air would still own today 42 percent of the stock of Eastern Airlines, stock that they purchased in the open market without any necessity of Eastern's involvement.

Because they talk about this lock-up option which they want to make the black knight of death, this lock-up option. But they don't tell the court that the lock-up option was never exercised.

It was an option available to Texas Air if a competing hostile tender offer had come along and tried to go directly to the shareholders of Eastern and tried to upset the Texas Air bid.

It was an option for them to buy an additional block of stock.

Because that never happened, it was never necessary to exercise the option.

And instead Texas Air simply went that the market place like anyone else has the right to do and bought the remaining stock that brought them to their fifty-one percent offering.

There was no need to ever exercise the lock-up option because there never not then and not now has been a competing.bid.

Plaintiffs whole house of cards falls when you understand that there was no competing bid for Eastern Airlines in February of 1986.

To the contrary, the board of directors beginning in 1985 had sought people to talk to because they knew then that this Airlines was in crisis, this company was in financial crisis.

Mr. Bailey said it is a question of life and death. Yet Mr. Bailey would have you believe the death of the Airlines by Frank Lorenzo and Texas Air because they are going to dismantle the airlines and scatter the pieces to the wind like ashes of a corpse.

Very eloquent, unsupported by the slightest shred of evidence other than Bailey on Lorenzo.

What was the life and death situation of Eastern Airlines was February of 1986 when Eastern Airlines was on its deathbed and the only entity that was willing to breathe life into Eastern Airlines, to put its money on the table to breathe that life was Texas Air.

Eastern had sought merger candidates for months as one of its options and it saught those candidates because its unions leaders couldn't see reality.

They come into court today, your Honor, having made yesterday for the first time a proposal to give Eastern Airlines 500 million dollars in wage concessions, not ratified by their membership but recommended by union leadership just yesterday.

Where were the unions in February of 1986? Where was the 500 million dollars in concessions when Eastern Airlines was on its deathbed, when the negotiators for Eastern Airlines were negotiating around the clock with the leaders of Eastern unions for those concessions that would allow them to accept that option of not selling the airlines to someone. It didn't exist. The evidence is uncontradicted.

We can argue about it in rhetoric now but the affidavits are there. A.L.P.A. had voted to support a strike. The T.W.U. contract had run out. The conciliation effort had ended.

Their positions even tentativel were dependent upon concessions being made by Mr. Bryan's union.

And as the affidavits uncontradicted in the record point out, up until the very last minute, directors of Eastern, outside disinterested, uninterested people at Eastern airlines whose only goal in life was to do the right thing for the shareholders of Eastern Airlines, went to Charley Bryant and said we can not survive without these concessions and he refused.

It is there in the affidavits of Mr. Bassett and Mr. Yeoman and the others.

They want this Court to believe today that back then they were talking about buying the airlines for the employees and they were some how knocked of the playing field by this lock-up option and no-shop agreement.

That is fantasy, your Honor. The facts are what I wish to deal with.

The facts are in January of 1986 just before the fateful events that they keep talking about, the leaders of the unions filed publicly with the S.E.C. a 13B because they were buying a sufficient amount of Eastern Airlines stock to require such a filing.

And they stated to all the world in that document they had no plans to form a group to seek control of Eastern Airlines, and that document is before your Honor.

And at the board of directors meeting held immediately thereafter after that filing, Mr. Magerno who sits with me at counsel table, general counsel and vice-president of Eastern Airlines, turned to a union leader and said, "Are you planning to buy Eastern Airlines? Do you have a group?"

And the leader of the T.W.U. said " No, we are not part of a group."

They sat through those negotiations in February of 1986.

I am happy to say that though they keep mixing up the facts and giving the impression that there was some offer on the table by the unions then in this oral argument.

When you read this papers and read their affidavits, it is clear that they have to admit not once on February 20th or 21st or 22nd or 23rd did Charley Bryan on Robert Callahan or any other leader of these unions come to the table and say "Here is an offer. We want to buy Eastern Airlines. We will pay this amount of money. We have the financing. We have an investment banker." Not even close.

As they have admitted in the papers they filed this morning, their last ditch offer was kick Frank Borman of the board and maybe we will make the concessions.

It was for the board of directors of Eastern in February of 1986 to decide whether kicking Frank Borman off the board to maybe get concessions from this union was a wise choice for shareholders of Eastern Airlines.

When one looks at the facts and not the rhetoric and not the eloquence, but the facts that are before the court in the record, we see that the first time that Charley Bryan ever so much as uttered his first "offer" of $10.25 a share was in a letter to the board of directors of Eastern on August 28, 1986, six months after the merger contract had been signed with Texas Air. That is the first mention of a number.

In that letter which is before the court as an exhibit to Mr. Magerno's affidavit, even in August, all the union was asking for was time, time to make arrangements for financial institutions to lineup financing, time to make filings.

That offer was conditioned upon the employees of Eastern Airlines, the employees, all of them, agreeing to concessions, to giving money out of their pocket which Mr. Bryan admitted in August he didn't have those concessions. He didn't have an investment banker.

What followed thereafter is a series of stops and starts where Mr. Bryan suggested to the board of directors of Eastern that maybe he would like to make an offer for Eastern stock starting in August an everytime he came to the board, the board asked him some very pointed business questions that this board of directors was obligated to ask him.

They said, "Mr. Bryan, do you have an investment banker?"

Answer, "No.

"Do you have a lawyer to deal with?"

Answer: "No.

"Do you have the commitments of the people you claim to represent that they will make those concessions?"

Answer: "No."

Each time those questions were asked Mr. Bryan went back and rethought about what he wanted to say, because in October of 1986 again it is in the record, the document is there, we are not talking rhetoric, in October of 1936 Mr. Bryan as a member of the board of directors asked at that time for the board of directors to postpone the Texas Air merger to give him another sixty days to come up with a proposal and to demonstrate financial ability.

And again the board of directors asks him business questions as they are supposed to do.

"Have you got an investment banker? Have you thought about this? Have you thought about that?"

And again on October 17th for the first time in history Mr. Bryan says he has now lined up an investment banker and a lawyer to talk about this and I will get something to you.

When does Mr. Bryan come back with what they first call their offer?

The first thing in their own documents that they even call, even try to dignify as an offer, November 10, 1986 the day this lawsuit is filed. Now nine months after have the contract is signed with Texas Air.

On that day they make a proposal which says, "well, contingent upon some thngs that may or may not happen, they will offer $10.25 a share."

And they talk about a ten million dollar deposit to be given up by the employees as a cash payment and they talk about needing another thirty days to find an investment banker who can raise 600 to 800 million dollars.

But the whole point is every time Mr. Bryan talks he says, "but of course you know this is contingent upon the Texas Air deal being off."

Well that's well and good but Texas Air and Eastern Airlines in February of 1996 signed a contract. And Eastern and Texas are bound by that contract.

Eastern is bound to this merger and most importantly for the shareholders of Eastern Airlines. It is those people who are supposed to be the plaintiffs here, not the unions.

The shareholders, all of the shareholders, most important for all of those shareholders, Texas Air was bound to that merger by a provision that we have referred to as the lock-in provision which was negotiated by the board of directors in return for the lock-up.

And that provision said even if Eastern Airlines goes bankrupt during this period of time that everybody knew it was going to take to get regulatory approval of this transaction, the six to eight months that everybody knew it was going to take, even if they go bankrupt in that interim, even in the unions strike if interim, Texas Air will carry out the obligation of this contract and will pay the shareholders the ten dollar merger considerations which the four independent investment bankers who have opined on this transaction have said is fair.

That's what the board of directors had. What the plaintiffs had was a request that the board of directors ignore all of that, and a wish and a prayer that Texas Air would simply say, "Okay you got me. It's a better offer. Here is my stock back. I am not interested."

That's the reality that plaintiffs ignore, that Texas Air today is the majority shareholder of Eastern and nothing can change that.

Even their stock purchases in the open market by any definition known to law puts them in control of the institution with forty-two percent if and when the question of any transaction were to come for a shareholders vote.

That proposal when the board of directors on November the 12th exercising in an abundance of caution beyond anything plaintiffs could ask for, even facing a binding merger contract, still said to the plaintiffs on November 10th, "We will listen to you. You understand we have a contract here and if way back out of the contract, we are going to get sued.

And who is going to suffer if Eastern Airlines gets sued? The shareholders of Eastern Airlines. That's who is going to suffer. But we will listen to you."

And once again on November 12th questions were asked of Mr. Bryan about this latest suggestion that he may have an actual firm offer to make somewhere down the road and once again, what happens?

Mr. Bryan goes back and changes his mind and he comes back yesterday, your Honor, and now the ten million dollar down payment is gone and now we have the offer put before the court yesterday conditioned upon 500 million dollars in wage concessions being agreed to, being ratified by the employees of Eastern which we are a long way from.

If we allow, if the law is as plaintiffs suggested that this kind of thing that can go on, that you can sign an agreement in February and have one proposal in April, another one in August, another one in October, another one in November the 12th, another one of November

18th, where would you ever have a contract that was binding and where would it ever end?

The delay in making anything and I don't want to dignify it by calling it an offer, but making anything, even suggesting a number that might be the basis of their offer, their delay in doing that exactly parallels their delay in trying to seek the relief which they have known from day one was critical to their attempt to succeed in this case.

We know what laches is. Your Honor knows what laches is. If I may for a moment paraphrase for a moment one of the old statements of laches. It is sleeping on your rights. As I said before it is 11:58.

Apparently what happened is that the plaintiffs forgot to set their alarm clark because they had been sleeping on this claim that they attempt to assert in this case since February of 1986.

If the plaintiffs have a claim, which I suggest they don't, but if the plaintiffs have a claim that the board of directors did something wrong in February of 1986, and that's gravamen of their whole case and that's the law, proving that the board of directors acted with gross negligence in February of 1986, if they had a claim why didn't they bring it in February?

Why didn't they bring it in March, April, May, June, July.

Instead, they sat there and they watched while Texas Air and Eastern spent hundreds of thousands of dollars in legal fees seeking regulatory approval of this transaction, while both Texas Air and Eastern Airlines sold valuable landing rights to Pan Am because it was necessary to the approval of this merger.

The Department of Justice and the Department of Transportation insisted that for this merger be approved that Pan Am be created in the northeast as a competitor to this merged entity on the shuttle service that they keep wanting to talk about.

While that went on the plaintiffs sat and they watched and they filed no suits. They sat and they wathced while Texas Air went into the open market place and bought enough stock to become the major shareholder of Eastern which it is today. They sat and they watched.

In March of 1986 on Exhibit 15 to Mr. Magerno's affidavit Mr. Bryan wrote a letter to a lawyer saying that an attorney unnamed had advised him that unless the lock-up could be stopped in court, there was nothing the unions could do to stop Texas Air from gaining a majority interest.

That was in March of 1986. Why didn't that lawyer run into court in March of 1986 and make take claim? Where was Mr. Bailey then?

In a March 29, 1986 bulletin to its membership Mr. Bryan said to members of the I.A.M. "it is being challenged on all fronts." But it wasn't being challenged in this courtroom.

In September of 1986 Mr. Bryan writes to the board of directors of Eastern and says, "you breached your fiduciary duties in accepting the Texas Air proposal," in exhibit three to Mr. Magerno's affidavit. It is there. Why wasn't he in court asking the court to stop it?

In October of 1986 the I.A.M. writes another letter to the board and again they say your breached your fiduciary duty.

Why weren't they in court if they believed that they had some right to stop this transaction.

They do not sue Eastern Airlines until November the 10th, 1986.

As the court in Heckell Ventures cited in our brief said so eloquently and so relevently, "any procedural prejudice to the plaintiffs by my not having sufficient time to develop a record to decide whether or not the board of directors of that corporation acted grossly negligently in granting a lock-up, is the fault of the plaintiffs who have sat by and watched."

In that case unlike the case at bar, plaintiffs only waited three weeks from the transaction in question and came in one week before the shareholders vote and tried to stop it.

Our plaintiffs have waited nine months, nine months during which the stock market reacted to this merger by sending the stock price of Eastern soaring.

It is those people who have bought and sold their stock on the basis of the facts and of reality. None of the shareholders who are supposed to be represented here by the plaintiffs-- this a derrivative action.

Mr. Lowey started out by saying there are twenty thousand members of the union whose jobs he is trying to save and I don't know where in this record, by the way, is there the slightest suggestion that these people are going to lose their jobs. But if he wants to say it, he can say it.

But the plaintiffs in this case which the plaintiffs representatives seem to keep missing are the shareholders of Eastern's and there are two hundred thousand shareholders of Eastern Airlines, and every one of them is going to receive ten dollars a share for their stock when this merger closes which Shearson Lehman, Merrill Lynch, Salomon Brothers and the Freeman company have all unanimously said is fair value for their stock.

Just as they slept on any alleged claims they have until 11:59 on the fiduciary breach, so to have they slept on their proxy claims.

They run into court and they say we have to stop the solicitation because of the proxy violations and I will not bore the court with the litany of our response to these silly challenges on the proxy of Eastern Airlines and the quibbling that goes on in the paper.

But as the uncontradicted evidence shows, the draft of the proxy was sent to the S.E.C. in June and released publicly by the S.E.C. in June.

Drafts of the proxy were given to Mr. Bryan and Mr. Callahan as members of the board in August of 1986. They had it in front of them. They could read it.

Indeed at the September 25th meeting of the board of directors Mr. Bryan came in and made comments about the proxy. He complained about a few statement where he says he was misquoted.

Yet if they felt there was a violation of law, a securities fraud in that proxy, did they go to court in June, July or August or September? No. They waited until 11:59.

Then they want to put on this Court with their eloquence and their rhetoric unsupported by the evidence, that somehow this airline is going to be scattered to the wind.

They want you to believe that and they know that your Honor can't possibly find today on the record before it, cannot possibly find that the board of directors was grossly negligence in accepting the Texas Air proposal.

But they want you to believe that even if you can't make that finding, you should stop this transaction.

Stop the transaction for what? To give them more time, the time they had since February to make an offer.

Now today what do they want? They want more time. What is the irreparable harm to the plaintiffs if they don't get more time?

Again I remind the court, who are the plaintiffs? The plaintiffs are not the unions. The plaintiff are not Mr. Bryan and Mr. Callahan. The plaintiff are the the two hundred thousand shareholders of Eastern Airlines.

Let's look at the two claims. Let's look at the irreparable harm.

The first claim is the proxy violation. What is the irreparable harm to the two hundred thousand shareholders of Eastern Airlines who are not Texas Air if this court doesn't enjoin the proxy solicitation? I submit absolutely none.

The merger as your Honor knows from the last time we were here, is going to go through no matter what the validity of Eastern Airlines proxy because Texas Air owns fifty-one percent of the vote and that's all it takes to aprove the merger.

So the merger will be approved next week no matter what the plaintiffs complaint about the proxy because if this court at final argument some day in this case were to find that Eastern Airlines' proxy was invalid and every proxy solicited by the company and if every other shareholder of Eastern Airlines voted against the merger, you would invalidate forty-nine percent of the proxy and the merger would carry.

So it can't be that. You can't be irreparably harmed by the proxy violation and indeed the plaintiffs don't even try that.

But what they try to say in their papers is even though Texas Air is going to approve this merger no matter what we do, all the other shareholders have appraisal rights and they have to know what to do and they have to know know whether to consent to the merger under Delaware law.

Nothing could be a better definition of a remedy at law than appraisal rights.

If this Court were to every find that there was something wrong with the proxy, it can simply award to any shareholder who wishes to complain about the merger consideration, their statutory right of appraisal right to give them a court awarded fair value for their merger stock.

That's dollars. That's all anyone could complain about even if all of the wild accusations of plaintiffs about this merger being "a lousy deal" which is Lowey on the deal as opposed to Shearson Lehman and Merrill Lynch and Salomon Brothers and their own investment bankers hired by the trust.

And if it with a lousy deal, the court simply cures that by awarding the damages to the shareholders. Simply set back the clock and say I have found that your proxy was solicited improperly. Any shareholder who doesn't want the ten dollars a share and would prefer to go through the statutory appraisal which is there only remedy, we will do it.

We will have a hearing and we decide maybe the value of Eastern's stock was really $10.50 and we will order the defendants to pay that.

But on the other hand as your Honor knows, the Court may decide that the value was really $8.50 but that is the risk that the shareholders will have to take. So there is no irreparable harm from the proxy.

What about merger itself. The whole proxy is really a smoke screen. They want to stop the merger.

I might add that I was so happy to hear plaintiffs saying we kept ignoring the smoke of the unions because I suggest to you that indeed that's all we every had was just smoke and not one iota of fire.

Well the irreparable harm to the shareholders can't be from what they are going to get in the merger.

That can't be because as I pointed out several times, we have four independent investment banking firms who have said to all the world in their considered opinion this is fair value.

It can't be irreparably harmed by getting the fair value. So that can't be the irreparable harm from let being the merger through.

Apparently and this brings us full circle back to where we started, back to the fundamental flaw of the plaintiffs whole case, what they want to say is the irreparable harm to the shareholders is the inability to get whatever it is the unions, if we give them another four months, might offer to the shareholders.

Why do I say four months? Because in the affidavit of the gentleman from the Kelso company the investment banker that the plaintiffs now say told them this week for the first time, that if we can stop the Texas Air transaction, or if we can ask Texas Air in a nice way to sell or get rid of the ten million shares of stock they already bought, and if we can get the employees of Eastern Airlines to agree today what they wouldn't agree to back then, 500 million dollars of concessions, we think within four months in their own opinion within four months, we can come up with a financable transaction.

This requires us to balance the harm of not getting that offer, not getting that gossamer possibility that Eastern has been waiting for for nine months, that in another four months the plaintiffs might have a financeable offer with what will happen to everybody, not just Texas Air and not just Eastern but the shareholders of Eastern, the true plaintiffs in this case, what will happen if this court grant the injunction.

What will happen very simply is this. The Texas Air proposal, this binding contract will be lost because the contract provides in clear and uncertain terms that if this transaction is not closed by December 31, 1985 it is of no further force and effect.

Why did Texas Air insist on a position like this? You need only read the Sneticker affidavit.

Texas Air has been through this before. Texas Air has attempted to buy other airlines and the unions who see Frank Lorenzo as the prince of darkness have tried to stop him before. And they have successfully stopped him by tactics that are discussed in the Sneticker affidavit.

Texas Air quite legitimately was not going to go on the line, not going to sign a deal and spend hundreds of thousands if not millions of dollars in legal fees and sell landing slots and do everything else that was necessary to buy Eastern Airlines unless it had some provision that guaranteed the merger would go through and unless it had a date beyond which the merger had to go through or they weren't going to continue to sit on the end of the line.

So balanced against the wing and the prayer that Eastern unions will come up in four months with an offer that is financed and may be marginally better than this offer, is the fact that right now today the shareholders all two hundred thousand of them will lose ten dollars per share right here, right now, it is on the barrel and it is about to close.

What will happen to Eastern Airlines? What the plaintiffs don't want to talk about is what has happened at Eastern in the last nine months conditioned upon this merger taking effect.

I suggest to your Honor I know where the unions got the five hundred million dollar figure. They know that Eastern Airlines cannot survive, cannot keep flying, cannot survive for anyone without an immediate infusion of five hundred million dollars of new capital. And Eastern

Airlines as we stand here today has that commitment in writing.

But that commitment from financing sources is contingent upon this merger closing by December the 15th, 1986. If this merger does not close by that date and it will not close by that date if this shareholders meeting is stopped for one minute, that five hundred million dollar commitment to Eastern Airlines will be lost.

THE COURT: Commitment from--

MR. ROSS: A capital source which is in the papers.

THE COURT: I mean banking sources. Financing sources.

MR. ROSS: That is correct.

THE COURT: And that is a commitment to Eastern Airlines conditioned upon this merger being executed and finalized by December 15, 1986.

MR. ROSS: That is correct. It in described in detail on pages 62 an 63 of the proxy. This action must be closed or that committment is gone.

THE COURT: Can I interpret from that argument that so long as this matter is finalized by December 15, 1985 that Eastern Airlines will not suffer that loss.

MR. ROSS: No, you can't, because, your Honor I will tell you what else happened just yesterday.

Just yesterday Eastern Airlines lost a one hundred million dollar commitment to finance the purchase of three new 757 aircrafts merely because this lawsuit is pending and the lenders who were going to lend Eastern Airlines that money, are nervous.

THE COURT: I am awfully sorry. I told you all you could walk all over the courtroom and that's fine so long as I can hear you when you get to whenever you are going. The beauty of one of these microphones is that I can hear you.

I hope I don't throw you off pace but I am missing a little bit there.

MR. ROSS: I am sorry.

THE COURT: You were starting to tell me about a hundred million dollars.

MR. ROSS: A hundred million dollar commitment to finance the purchase by year end of three 757's.

The lenders told Eastern yesterday they would not go through with it because of this lawsuit and the union attack on this merger has frankly scared the daylights out of them.

And they are not going to lend a hundred million dollars to a company that might end up right back in the throws of where they were in February of 1986, a company with no infusion of capital forthcoming, a company fighting with its unions, a company waiting on the hope that its unions may someday agree to the concessions that they could have agreed to in February of 1986 and didn't.

If the merger doesn't close and for it to close by year end that meeting has to go forward right now as scheduled. It took us forty-five days to notice that meeting in the first place under Delaware law.

THE COURT: Forty-five days.

MR. ROSS: Under Delaware law and S.E.C. requirements.

THE COURT: The requirements to notice the meeting for next Tuesday, there is a requirement for forty-five days for notice of that?

If you miss that deadline for that meeting for any reason, you presumably could not get it reset for another forty-five days.

MR. ROSS: They are overlapping requirements plus we would have to issue new amendments to the proxy material.

MR. LOWEY: I would rise if I may. This is a point that is so absolutely wrong that I must rise to it.

There is no barrier in Delaware law to have an adjourned meeting and there is no forty-five days requirement and Mr. Welsh as a lawyer from Delaware knows this and I dare Mr. Welsh to stand up and tell me that I am wrong.

THE COURT: Gentlemen, just a moment. You will get an opportunity. He is presenting his interpretation of this requirement.

I was about to observe that there is more similarity to what Mr. Bailey said earlier about this being a capital case, the similarities keep cropping up.

When the governor signs a death warrant and makes it effective during a thirty day period which is what our Governor Graham has done, then that warrant must be executed within the thirty day period, or if it is not carried out with that thirty day period for whatever reason, then the governor must sign a new death warrant.

So we are getting more and more similarities to a capital case, same deadlines apply in business or capital cases.

Go ahead, sir. You were telling me they will withdraw a hundred million dollars for the financing of three 757's.

You were going through the other items that you felt would be irreparable injury to Texas Air or perhaps the stockholders of Eastern or Eastern Airlines if the merger did not go through.

MR. ROSS: That's correct and I won't get into that debate.

There is a very simple answer. Plaintiffs themselves say they need four months and if the merger doesn't close by December 31st, it is off. It's over.

THE COURT: As long as we all interrupted you, something right on this pointand I will ask both sides this.

Is there any room in these delicate negotiations and the contracts that have been entered into between Texas Air and Eastern Airlines, is there any room at all for some time for the court to develop in a more traditional fashion a factual record.

I will give both of you the chance. He is an aggressive young man, Mr. Bailey. He keeps wanting to get to his feet. You used to be that way.

I am going to ask both of you this question and I know I am impinging on your time. We will give you a few minutes.

The point is, is there any room at all for something like thirty day, sixty days, ninety days to develop some factual basis in consideration of an application for temporary injunction.

MR. ROSS: No, your Honor. I submit the answer is no. The merger agreement will terminate. The five hundred million dollar commitment will be lost.

THE COURT: Those things won't happen until

December 15th.

MR. ROSS: Well, your Honor asks if there was 30 or 60 or in the days.

THE COURT: Well, all right, it is is November 21st. When you are trying cases everyday, you forget what month it is.

So we are now at November 21st. You are saying that the absolute deadline is December 31st for the merger agreement to go by the boards and you suggest that the procedural steps necessary to having a stockholders meeting at least in your opinion, your colleagues' opinion forty-five days which would place it past that period, that date. So this is sort of it.

MR. ROSS: As far as we are concerned, this is it. If the plaintiffs wanted more time, they have had nine months.

THE COURT: You have made that quite clear. I believe I understand your position on that.

MR. ROSS: I might point out, your Honor, that just the amendment to the proxy alone which was made necessary by the actions of the unions in the last couple of days because everytime they do something, we have an obligation to amend our proxy and advise the shareholders of what is going on.

Just sending out of the supplemental proxy this

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way or the other.

It is simply to see if there is any room at all forgetting the fact that it is weekends or holidays or nighttimes, that is unimportant.

If there is any time at all available in some fashion for the Court to develop a factual record, taking testimony, if not all, at least some of the principals, but to get some sort of better record, then that's the sort of thing that I am sure Judges everywhere would take a good hard look at to see if they couldn't accomplish.

That's the only reason for the question. I am concerned about it because right now you are asking me to make a decision based purely on the briefs, the written briefs submissions of the attorneys, and the exceptionally fine oral submission that is being presented here today, but without the traditional record.

I know you have referred me to Judge Aronovitz's case where you said that fault must be laid at the feet of the plaintiffs for waiting so long.

Bit that he is not all together comfortable no matter whose fault it is.

It would be intolerable if it was my falult, but it doesn't matter whose fault it is because if there is a way to get at some sort of opportunity for the parties to present their case a little more fully, why that's what we are groping for.

Your position is that there is no time left. We are at November 21st. The financing will start to fall through buy December 15th.

The merger deal will be completely off by December 31st and in the interim certain things are happening in the real world of financing where financing is being withdrawn as recently as yesterday.

All right. Fine. I am sure that you will have something to say about all this but I am trying to get his position. Mr. Ross go ahead.

MR. ROSS: Let me also point out that there is indeed a factual record before your Honor. Both sides have submitted extensive affidavits of the witnesses who would testify.

THE COURT: Yes. I know and unfortunately I am still taking six or seven hours a night to sleep.

I shouldn't do that. I should read your extensive memorandums in my free time.

MR. ROSS: I wanted to conclude by point out that the time requested by the plaintiffs is of no benefit to anyone, because as I started by saying, Texas Air is the majority shareholder of Eastern Airlines today and it will continued to be that even if the merger contract were thrown out by plaintiffs, because the stock was bought out there in the open market.

No one can order Texas Air to give that stock back under any circumstances.

THE COURT: Even if perhaps they obtained the information, even if perhaps obtained as counsel for plaintiffs suggest confidential insider information that the normal stock purchaser in the open market would not have been privy to, even if Mr. Borman wth the finest of motives was giving to Mr. Lorenzo information about routing and income and out go and employment records and everything else, that he wouldn't give to you or Mr. Bailey if you walked into the local stock brokerage hosue and said I want to buy a position in Eastern Airlines.

Would that have any bearing? They suggest it might. They say maybe the defendant, Mr. Lorenzo or Texas Air enjoyed a very unique position here with a lot of insider information.

MR. ROSS: Aside from the fact that there is not a shred of evidence of that before the court in any affidavits, even the plaintiffs, nevertheless that argument only addresses Texas Air's entering into this merger arrangement which resulted in buying only a small portion of the stock they own.

The point is that after this merger agreement--

THE COURT: Eighteen percent.

EXHIBIT D

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA.

CASE NO. 86-2378-CIV-KING

NOTICE OF TAKING DEPOSITION

ELIZABETH A. HASTINGS-MURTAGH,
et al.,

Plaintiffs,

vs.

TEXAS AIR CORPORATION, a
Delaware Corporation, et
al.,

Defendants.

AMENDED
VERIFIED
COMPLAINT

TO: All counsel of record as set forth on the
attached service list

PLEASE TAKE NOTICE that pursuant to Rule 30, Federal Rules of Civil Procedure, that on the 16th day of December, 1986, beginning at the hour of 9:30, a.m. at:

Bailey, Gerstein, Rashkind & Dresnick
Office at Bay Point
4770 Biscayne Boulevard
Miami, Florida 33137

before a notary public or court reporter, who is authorized by law to take depositions in the State of Florida, the Plaintiff will, upon oral examination, take the deposition of the following named party Defendant, to wit:

FRANCISCO "FRANK" LORENZO

Such oral examination will continue from day to day until completed. You are hereby notified to appear and take part in said examination as you may be advised, and as shall be fit and proper.

This deposition is being taken for the purposes of discovery, for use as primary evidence or for such other purposes as are permitted under the applicable Statutes or Rules of Court.

I hereby certify that a copy of the foregoing has been furnished to the above named addressees by U.S. mail or Federal Express, as indicated on the attached service list this 8th day of December, 1986.

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

Elizabeth A. Hastings-Murtagh, Daniel F. Murtagh and Larry Schulte, on their own behalf and on behalf of all other employee-common stockholders similarly situated and on their own behalf and on behalf of all other 20% Participating Preferred Stockholders similarly situated and EAL Employees Coalition Acquisition Corp., an Illinois Corporation, Charles E. Bryan, and Robert V. Callahan,

Plaintiffs,

v.

Texas Air Corporation, a Delaware Corporation, Frank Lorenzo, Philip Bakes, Frank Borman, Joseph B. Leonard, Wayne A. Yeoman, Harry Hood Bassett, Peter O. Crisp, James A. Elkins, Jr., Karl Eller, John T. Fallon, Robert D. Lund, Enrique Madero, Thomas O. Paine, Wesley W. Posvar, Julian Scheer, Thomas R. Williams, David W. Wallace, Elmer L. Ward, Jr., TAC/EAL Acquisition, Inc., a Delaware Corporation, Eastern Air Lines, Inc., a Delaware corporation.

Defendants.

CASE NO. 86-2378-CIV-KING

First Amended Verified Complaint - Class Action for Damages and Declaratory and Injunctive Relief

JURY TRIAL DEMANDED

FIRST AMENDED VERIFIED COMPLAINT - CLASS ACTION

Elizabeth A. Hastings-Murtagh ("Hastings-Murtagh"), Daniel P. Murtagh ("Murtagh"), and Larry Schulte ("Schulte") bring Counts I through III of this action on their own behalf and on behalf of the class of employee-common stockholders of Eastern similarly situated pursuant to Rule 23 of the Federal Rules of Civil Procedure ("Rule 23")for damages and declaratory and injunctive relief. Hastings-Murtagh, Murtagh and Schulte also bring Counts IV and V of this action on their own behalf and on behalf of the class of 20% Participating Preferred Stockholders of Eastern pursuant to Rule 23 for damages and declaratory and injunctive relief and Count VI derivatively on behalf of Eastern Airlines, Inc., pursuant to Rule 23.1 for damages and declaratory and injunctive relief. E.A.L. Employees Coalition Acquisition Corp. ("Coalition Corp."), Charles E. Bryan ("Bryan") and Robert V. Callahan ("Callahan") bring Count VII of this action directly for their own benefit. Plaintiffs allege upon knowledge, information and belief, as follows:

Introduction

1. On February 24, 1986, employees of Eastern Air Lines, Inc. (referred to hereinafter as "Eastern" or "Company") beneficially owned in excess of 25% of the common stock of the company -- they were collectively Eastern's largest shareholder. In the preceding months, Eastern's approximately 40,000 employees had been engaged in a vigorous campaign to purchase additional Eastern stock on the open market, in addition to the stock already owned by employee trusts. However, without exploring in any respect the possibility of selling the company to Eastern employees, or even contacting those employees or their representatives with whom they had negotiated in the past to see what interest they might have in acquiring the Company, Eastern was "sold".

2. The merger agreement was approved by a vote of the common shareholders on November 25, 1986. This vote was predetermined by a course of action which included secret meetings, disclosure of confidential information, insider trading, breaches of fiduciary duty and proxy misrepresentations in violation of the Securities Exchange Act of 1934 and rules of the Securities and Exchange Commission.

3. As alleged in this amended complaint and commencing sometime during 1985, Frank Borman, Chairman of the Board of Eastern, sought a candidate for an acquisition or merger. However, a condition was that Eastern, and more importantly its management, would be the surviving entity.

4. As early as December 4, 1985, Frank Lorenzo, Chairman of Texas Air Corporation, discussed the prospective purchase of Eastern by Texas Air with Borman. This may have been the first conversation in which Eastern management acknowledged that Eastern would not be the dominant company but that Eastern management would have to survive. The information that Eastern was receptive to an acquisition by another company was confidential information. Additional confidential information, including financial projections and forecasts, was provided to Texas Air. This material information was not disclosed to the public and

after obtaining such information without first disclosing it to the public. Texas Air, it agents and affiliates, at least by December 4, 1985, became an insider to Eastern and stood in the same relationship to Eastern as management of Eastern. Despite this, with or without the tacit agreement of Eastern management, Texas Air began a program of purchasing the common stock of Eastern on January 22, 1986. By the time of the merger agreement, Texas Air controlled 4.8% of the common stock of Eastern. The shares were purchased at a time when the public was not aware of Eastern's potential acquisition or the other confidential information. While Texas Air has claimed in a Form 13D filing that the purchases were for investment purposes, Texas Air's counsel has acknowledged that "We didn't buy Eastern's stock to try to speculate on it; we bought it to build an airline system." (Oral argument transcript p. 116)

5. At the same time as Texas Air's purchase, Eastern's Board of Directors and Management took extraordinary steps to stop any other prospective purchasers - particularly employee stockholders - from obtaining control of the company. They passed "poison pill" provisions, a special director's indemnity fund and gave management golden parachutes to assure their cooperation. Finally, through the Executive Committee Eastern's investment banker was authorized to contact Texas Air, all this being done in secret without disclosure to the Board of Directors.

6. As of February 21, 1986, when the Eastern Board authorized negotiations with an unknown suitor, Texas Air had

already had access to confidential information for two months and was in fact a significant shareholder. As was predetermined, Texas Air was the only entity given an opportunity to bid for Eastern. No other purchaser was sought nor could any other potential suitor have been able to act in time. The timing of the events were manipulated to create a sought for inevitable result. This was the obvious intent of all concerned, a fact which Texas Air is bold to admit.

7. The unions were to either give the demanded concessions or the airline was going to be sold to Texas Air and no one else, perhaps as punishment for the unions and but with a detriment to the stockholders. The course of conduct of Eastern Management and the Board culminated in a merger agreement which in effect locked up Eastern on terms and conditions that may have been determined as early as mid-December, 1985.

8. The Board of Directors of Eastern ("Board") precipitously approved on February 24, 1986, at 2:30 a.m., an inadequate take-it-or-leave-it merger proposal from Texas Air Corporation ("Texas Air") that had been presented to the Board for the first time only twelve hours earlier. All of the directors present, except four who had been designated by the three employee unions, voted to preclude all other potential bidders for Eastern by agreeing to finance the acquisition by Texas Air of a large block of newly issued Eastern common stock, issuing to Texas Air a stock "lock-up" option and agreeing to an ironclad "no-shop" provision, although this was the first and only offer [illegible] At the same time, the defendant

directors authorized Texas Air to acquire additional Eastern shares in the open market which, when added to the lock-up shares financed by Eastern and those shares subject to the lock-up option, would give Texas Air 51% of Eastern's outstanding common stock -- and the power to approve the merger -- even if all other Eastern shareholders voted against it. Further, Texas Air was permitted to pay for Eastern by refinancing Eastern's assets and pledging its income. Texas Air induced Eastern's Board to conclude the transaction on Texas Air's terms, without considering its consequences or investigating alternatives and in disregard of the shareholders' interests, by agreeing to provide Eastern's directors $35 million of indemnification.

9. The expressed interest of representatives of Eastern's employee shareholders in making a bid to buy the company was ignored. Eastern management and its Board knew full well that Eastern's employee shareholders were willing buyers of the company.

10. Following Texas Air's agreement to indemnify them, the defendant directors approved the Texas Air merger proposal with only the most cursory review of its terms, and over the refusal of the outside directors' own investment banking firm to issue a fairness opinion before the deal was struck. In approving the Texas Air merger proposal while effectively nullifying any real opportunity for stockholders to vote down the transaction and locking out all other bidders for Eastern, the defendant directors were grossly negligent and breached their duties of

loyalty and care, all to the irreparable detriment of Eastern, its shareholders, and its employees.

11. Furthermore, as described herein, the proxy statement issued in connection with the proposed merger is deceptive and misleading in material respects, and it fails to include information required by Securities and Exchange Commission rules.

12. The financial markets immediately recognized that the Texas Air proposal enriched Texas Air at the expense of Eastern shareholders. Texas Air's stock soared over 70% within a week of the announcement of the merger.

13. Plaintiffs Hastings-Murtagh, Murtagh and Schulte bring this action on their own behalf and on behalf of the class of similarly situated employee-common stockholders of Eastern, to ① recover damages suffered as a result of the acceptance by the Eastern Board of the inadequate Texas Air offer; to ② unwind the merger with Texas Air; to ③ invalidate the Merger Agreement, including the inducement fee, the no-shop provision, the lock-up option, and Texas Air's purchases of Eastern stock, all of which were approved by the defendant Directors in violation of their fiduciary obligations and Delaware law; and to ④ direct the Eastern Board, after unwinding the Texas Air merger, to consider in good faith the pending offer of plaintiff Coalition Corp., which offer is clearly superior to the Texas Air offer and is in the best interests of all Eastern shareholders.

Jurisdiction and Venue

14. This Court has jurisdiction over Counts I and IV

under Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. 78aa. This Court has jurisdiction over Counts II and III and V through VII under principles of pendent jurisdiction, inasmuch as such claims arise out of the same nucleus of operative facts as the Federal claims.

15. In connection with the acts and conduct alleged in this Complaint, the defendants, directly or indirectly, used the mails, the instrumentalities of interstate commerce and the facilities of national securities markets.

16. Venue is proper in this district pursuant to 28 U.S.C. 1391. Many of the acts alleged herein occurred in the Southern District of Florida, and the claims as alleged herein arose in this District. The principal place of business of Eastern is in Dade County and among other events the Board meeting on February 23-24 took place at company headquarters.

17. Plaintiffs seek a declaratory judgment pursuant to 28 U.S.C. Section 2201.

Parties

18. Plaintiff Hastings-Murtagh was at all relevant times an employee of Eastern and a beneficial owner of common stock of Eastern. She also has owned beneficially, at all relevant times, shares of 20% Participating Preferred Stock of Eastern. Further, on February 11, 1986, she bought an additional 1,400 shares of Eastern common which she sold on May 23, 1986.

19. Plaintiff Murtagh was at all relevant times an employee of Eastern and a beneficial owner of common stock of

? times, shares of 20% Participating Preferred Stock of Eastern.

20. Plaintiff Coalition Corp. is a newly formed Illinois corporation, formed to facilitate the acquisition of Eastern by merger on behalf of its employees. Its initial shareholders are Eastern's employee unions.

21. Plaintiff Bryan was at all relevant times an owner of common stock of Eastern, President and General Chairman of District 100 of the International Association of Machinists and Aerospace Workers ("IAM"), which represents approximately 12,000 Eastern machinists, a Director of Eastern, and is an officer of Coalition Corp.

22. Plaintiff Callahan was at all relevant times an owner of common stock, and 20% Participating Preferred, of Eastern, is an Eastern employee, and President of Transport Workers Union ("TWU") Local 553, representing approximately 6,800 Eastern flight attendants, a Director of Eastern, and is an officer of Coalition Corp.

23. Plaintiff Schulte was at relevant times an owner of common stock and a beneficial owner of 20% Participating Preferred Stock of Eastern, an Eastern employee, President (or past President) of the Air Line Pilots Association, International ("ALPA"), Eastern Air Lines Master Executive Council, which represents Eastern's pilots and certain other personnel, and an officer of Coalition Corp.

24. Texas Air is a Delaware corporation, with its principal executive offices in Houston, Texas. Texas Air is a

holding company, the principal holdings of which are a majority position in Continental Airlines, and all of the common stock of New York Air, CCS Automation Systems, Inc. and Texas Air Leasing Corporation. In addition, Texas Air has agreed to acquire People Express and has acquired assets of Frontier Airlines.

25. TAC/EAL Acquisition, Inc. is a Delaware corporation. It was a wholly owned subsidiary of Texas Air, and was merged into Eastern on November 25, 1986.

26. Defendant Francisco "Frank" Lorenzo ("Lorenzo") is Chairman of the Board and Chief Executive Officer of Texas Air and of Continental Airlines, and on October 17, 1986, was elected by Eastern's Board to be its Chairman and a Director of Eastern.

27. Defendant Philip Bakes ("Bakes") was, until October, 1986, President of Continental Airlines. On October 17, 1986, the Eastern Board elected Bakes as President and Chief Executive Officer, and a Director of Eastern.

28. Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition, Inc., conspired with and aided and abetted the defendant directors in breaching their fiduciary duties to plaintiffs and Eastern's other shareholders and are liable together with the other defendants for the wrongful acts alleged herein.

29. Defendant Frank Borman ("Borman") was Chairman of the Board, Chief Executive Officer and a Director of Eastern until his resignation, effective as of July 1, 1986, at which time he became a Director and Vice Chairman of Texas Air.

30. Defendant Joseph B. Leonard was President, Chief

Operating Officer and a Director of Eastern and also became acting Chief Executive Officer, effective July 1, 1986, until he was replaced by defendant Bakes at the direction of defendant Lorenzo. Leonard voted to accept the Texas Air offer.

31. Defendant Wayne A. Yeoman was Senior Vice President-Finance and a Director of Eastern, and voted to accept the Texas Air offer.

32. Defendant Harry Hood Bassett was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

33. Defendant Peter O. Crisp was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

34. Defendant James A. Elkins, Jr., was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

35. Defendant Karl Eller was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

36. Defendant John T. Fallon was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

37. Defendant Robert D. Lund was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

38. Defendant Enrique Madero was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

39. Defendant Thomas O. Paine was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

times a Director of Eastern, and voted to accept the Texas Air offer.

41. Defendant Julian Scheer was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

42. Defendant Thomas R. Williams was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

43. Defendant David W. Wallace was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

44. Defendant Elmer L. Ward, Jr., was at all relevant times a Director of Eastern, and voted to accept the Texas Air offer.

45. Defendant Eastern, following the challenged acquisition by Texas Air, is a subsidiary of Texas Air and is a corporation organized and existing under the laws of the State of Delaware, with its principal executive offices in Miami, Florida. Eastern is a commercial airline, flying domestic and international routes. It ranks as the second largest air carrier in the free world based upon the number of passengers carried, and the third largest certificated United States air carrier based upon scheduled revenue passenger miles flown domestically and internationally.

46. Defendants Lorenzo, Bakes, Texas Air and TAC/EAL Acquisition, Inc., on and after February 24, 1986, were, individually or in conjunction with others, controlling persons of

Eastern within the meaning of Section 20 of the Securities Exchange Act of 1934 and were affiliates of Eastern within the meaning of Section 13(e) of that act. Each of the director defendants except Lorenzo and Bakes was, individually or in conjunction with others, such a controlling person of Eastern at all pertinent times.

Facts Common to All Counts

Background

47. Since the late 1970's, Eastern's financial performance and its performance in the marketplace have lagged the performance of many of its competitors. Eastern's management has been unable to effectively address the economic and competitive pressures which have prevailed in the industry as a whole.

48. Eastern's failure to achieve financial stability and to achieve the competitive success experienced by other airlines of comparable size has occurred despite Eastern's possession of a number of uniquely valuable assets. These include a sophisticated computerized reservation system, a profitable and dominant Eastern Seaboard (Boston - New York - Washington) shuttle service, a wealth of valuable landing "slots" at volume-controlled airports, valuable South American routes acquired from Braniff, and a major hub in Atlanta which, while shared with another large airline, has been free of any significant fare wars.

49. Eastern management has consistently responded to its economic and competitive problems by demanding that its em-

ployees agree to wage and other concessions. Eastern management has continually threatened to put the company into bankruptcy or to take other steps that would have effectively resulted in the elimination of the company and the jobs of its employees if the employees did not agree to such concessions. In some instances, in consideration of such concessions, Eastern's employees have acquired shares of the common stock of the company or other rights to share in the profits of the company, and have achieved representation on its Board, and have otherwise obtained the right to participate in the management of Eastern. As a result, Eastern's employees have gradually become significantly involved in the management of Eastern, and the possibility of the employees purchasing the company had crystallized as a viable alternative and a solution to its financial problems.

(a) From 1977 to 1982, Eastern's employees contributed about $150,000,000 to Eastern's operations through wage concessions. In two of these years, these employees received a share of Eastern's profits in return for these concessions; the profits received by the employees in this manner were $140,000,000 less than the concessions obtained by the company. In 1980, each Eastern employee received 10 shares of the common stock of Eastern in lieu of any cash distribution pursuant to Eastern's Variable Earnings Program.

(b) In 1982, the Investment Bonus Agreement was initiated pursuant to which, in return for wage concessions, Eastern's employees were to receive a percentage of the company's profits.

(c) In June of 1983, after Eastern management threatened to place the company in bankruptcy, Eastern employees were encouraged to make voluntary contributions to the Investment Bonus Agreement and the employees agreed to defer some retroactive pay to which they were entitled. In addition, the pilots agreed to accept convertible subordinated debentures in return for wage concessions. The pilots were also allowed to appoint two members to Eastern's Board.

(d) In September of 1983, Eastern management again threatened to place the company in bankruptcy if the employees did not agree to a 20% wage reduction and a waiver of accrued vacations. Eventually, the employees agreed to an 18% wage deduction pursuant to which the wages so deducted were to be used to purchase 12,000,000 shares of Eastern common stock and an additional 3,000,000 shares of preferred stock which was eventually to be converted into an additional 3,000,000 shares of common stock. This program was referred to as the Wage Investment Program. As a result of the Wage Investment Program, Eastern employees acquired the ownership of 25% of Eastern's common stock and collectively were by far the largest shareholder of the company.

(e) In addition to obtaining the right to purchase up to 15,000,000 shares of the common stock of the company, under the Wage Investment Program, through trusts established for members of Eastern's three major unions the employees also received pre-emptive rights to purchase additional shares of the common stock of the company in the event of future stock offerings.

(f) In the Fall of 1983, Eastern management also agreed that the flight attendants (TWU) and the machinists (IAM) would each be entitled to appoint one representative to Eastern's Board of Directors. These seats were in addition to those previously granted to the pilots (ALPA) and brought the total number of employee seats on the Board of Directors to four. Eastern's management also agreed that Eastern's employees would be entitled to review Eastern's financial records on a regular basis and would be consulted regarding a variety of management decisions before they were made.

(g) The Investment Program pay deductions were originally scheduled to terminate on December 31, 1984. However, Eastern management unilaterally announced in late 1984 that the company would continue the 18% wage deduction throughout 1985, but without any provision for additional purchases of Eastern common stock on behalf of the employees. On February 7, 1985, Eastern management again threatened to place the company in bankruptcy unless the employees agreed to the continuation of the Wage Investment Program as amended. The machinists agreed to the continuation of the concessions with the proviso, however, that the wage cuts were to be restored if certain production efficiencies were realized.

(h) In 1983 negotiations over Wage Investment

Program, the unions requested that they be given a right of first refusal with respect to the company's stock in the event of the proposed sale of the company to some third party. No agreement was reached to provide the unions with such a right of first refusal.

(i) In the fall of 1985, the machinists agreed to an additional 5% wage concession.

(j) By the end of 1985, Eastern employees had contributed more than $900,000,000 in wage and other concessions to the Company over the past decade. They also held four seats on the Board and owned in excess of 25% of the common stock of the company.

50. In early 1986, all three Eastern unions embarked upon an extensive public campaign to encourage their members and non-union employees to purchase Eastern common stock for the purpose of increasing the influence of the employees in the management of the company. The three unions formed a coalition which in turn filed a Form 13D with the Securities and Exchange Commission on January 30, 1986 disclosing their intent to increase the extent of employee ownership of the common stock of the company.

51. These actions were interpreted by Eastern management as an effort by the employees and the unions to obtain a majority of the stock of the company. At the Board meeting of January 31, 1986, Plaintiff Bryan was confronted by Eastern management and directed to explain his intentions with respect to

the purchase of a controlling interest in the company. Similarly, union representatives were denied access to financial and other information relating to Eastern which they had previously been allowed to examine, because management was concerned that such information might be used to further an effort to buy control of Eastern. "Poison Pill" provisions were adopted January 31, 1986 by the Board to thwart any employee effort to acquire control of the company. There can be no question that the Board knew then that the employees were a known willing buyer.

52. Earlier, in November, 1985, Eastern instructed its investment banker, Merrill Lynch Capital Markets ("Merrill Lynch"), to prepare a valuation study of Eastern to facilitate an evaluation of options regarding the sale of some or all of Eastern or its assets.

53. Despite the demonstrated interest of representatives of Eastern employees -- collectively the company's largest shareholder -- Borman failed to explore the possibility of an employee purchase of the company. A strategy not grounded in any legitimate business purpose led Borman to fail to contact any of the leaders of Eastern's unions with respect to a possible employee purchase as had been done in the past. Subsequently, the likelihood that golden parachute provisions agreed to by Eastern's Board would not survive negotiations with an employee group also contributed to Borman's continued disregard of the acquisition interests of Eastern's employees.

The Texas Air Contacts

✓ 54. On December 4, 1985, Borman met with Lorenzo. They discussed the possibility of a friendly acquisition of Eastern by Texas Air, and agreed to meet at an early date. Borman agreed to provide Lorenzo with certain confidential financial projections.

55. Lorenzo used the inside information provided by Borman that Eastern was for sale to acquire on the open market over the subsequent 2 months just under 5% of Eastern's outstanding common stock.

56. Borman on information and belief intended to use the threat of a takeover by Lorenzo as a coercive measure to force concessions from Eastern's three major unions. In fact in October, 1985, the unions publicly predicted this strategy. Lorenzo was well known in the industry as the individual responsible for thwarting the efforts of employees of Continental Airlines to purchase that troubled airline in 1983, by buying the airline and placing it into bankruptcy, thereby abrogating union contracts. A sale of Eastern to Lorenzo was considered a suitable "punishment" for the unions if concessions were not forthcoming.

✓ 57. On December 10, 1985, Borman and Lorenzo met again to discuss the possibility of a Texas Air offer. Prior to this meeting, Borman had provided Texas Air with confidential financial documents of Eastern. At the December 10 meeting, Lorenzo again indicated an interest in a Texas Air acquisition of Eastern, if such an offer would be welcomed by Eastern's management.

Labor Negotiations

58. As part of predetermined strategy, Eastern embarked upon the highly unusual course of requesting the release of the negotiations for the TWU and ALPA contracts from the National Mediation Board thereby accelerating the prospect of a strike and the resultant loss of revenue in anticipation thereof by travel agents.

59. During on-going collective bargaining negotiations, TWU established a strike deadline of January 20, 1986, and ALPA a February 26, 1986, deadline. The collective bargaining agreement with IAM had approximately 20 months to run.

60. ALPA and TWU informed Borman in January, 1986, that they were willing to consider substantial wage reductions in new collective bargaining agreements.

The Texas Air Negotiations

61. According to the Proxy Materials, on February 14, 1986, Eastern's executive committee authorized Merrill Lynch to contact Texas Air to indicate Eastern might be open to merger discussions in the near future.

62. At a Board meeting on February 21, 1986, Borman indicated that a "specific entity" had expressed interest in acquiring Eastern. Borman refused to reveal that the entity was Texas Air, because he claimed Lorenzo had threatened to withdraw from any possible transaction if Texas Air's identity were disclosed. The Board blindly passed a resolution directing Borman to pursue discussions with that "entity."

63. Eastern management had recognized the potential attractiveness of Eastern to potential buyers when it adopted certain "poison pill" provisions in January, 1986, designed to act as a shield against "unwanted" bids for the company, including bids which might be made by the employees.

64. Unbeknownst to Board members Bryan, Callahan and to some other members of the Board, Borman already had made arrangements to produce an offer from Texas Air on a moment's notice as the February 26 strike deadline with ALPA approached. Almost immediately after the February 21 Meeting was adjourned, Borman placed a single, pre-arranged telephone call to Lorenzo, who offered to purchase Eastern on behalf of Texas Air. Lorenzo imposed a 48-hour deadline on Eastern's Board to accept his offer. Borman immediately agreed to present Lorenzo's offer to the Board.

65. Despite the impending deadline placed by Lorenzo on the Texas Air proposal, Borman did not immediately present it to the Board. Rather than meeting with the Board, on February 22 Borman met with the leaders of ALPA, IAM and TWU. He announced Lorenzo's offer and stated that it would remain open only until midnight, February 23. Borman then delivered an ultimatum: either the unions would enter into the concessionary labor contracts previously demanded by Eastern management prior to Lorenzo's deadline, or the Board would sell the company.

66. On information and belief' some or a majority of the directors and management had determined that Eastern should be sold to Texas Air in any event.

The February 23 Board Meeting

67. At 2:00 p.m. on February 23, 1986 -- almost 48 hours after the proposal was communicated to Borman and within 10 hours of the deadline imposed by Lorenzo -- a meeting of Eastern's Board was convened to consider Texas Air's merger proposal. Although no written merger agreement was made available to the Board at that time, Eastern's counsel briefly described the terms of the proposed deal to all of the members of the Board, except Willie C. Robinson, who was not present. According to the Texas Air proposal, Eastern would be the surviving company following the merger of a wholly owned Texas Air subsidiary into Eastern. Eastern's shareholders would receive for each share of Eastern common stock (i) $4.50 in cash; (ii) $1.75 in cash to be realized from the sale of certain Eastern securities; and (iii) junk bonds to be issued by Eastern with a face value (but not a market value) of $3.75.

68. During the Board meeting, representatives of Merrill Lynch briefed the Board on the Texas Air offer, and on the results of the Merrill Lynch valuation study which had been commissioned in November, 1985. The valuation study reflected current (at the time of the study) labor costs and did not take into account possible realignment or redeployment of assets to enhance value. Wage concessions which were, in fact, tentatively agreed to by two unions during the weekend negotiations were deemed "speculative" by Merrill Lynch, and were not considered in Merrill Lynch's valuation report. Nor did the valuation assess the likelihood of a potential offer for Eastern at any particular price level, the likelihood of a potential offer coming in a particular form of consideration or structure, or the likely acceptability of any particular offer to the Board. The valuation study was "theoretical in nature," as Eastern admits in its Proxy Materials.

69. The Board failed to give Merrill Lynch any guidelines to follow in preparing the valuation study. The study was prepared before the terms of any bid had been presented to the Board. Despite the admittedly theoretical nature of the valuation report, the Board failed to require a revised valuation report specifically addressing issues relevant to the proposed merger, including the achievement of significant labor concessions, a substantial reduction in fuel costs which was an unfolding circumstance at the time of the merger, and the value of Eastern's wealth of "slots" at volume-restricted airports, the marketability of which was also an unfolding development at the time of the merger. Other valuable assets of Eastern were simply not included in the valuation report.

70. Inadequate and misleading as it was, the valuation study nonetheless indicated a potential value for Eastern as high as $10.81 per common share if Eastern were sold as a whole, and as high as $13.41 per share if Eastern assets were sold on a segment-by-segment basis.

71. The meeting was adjourned at approximately 5:00 p.m. When it reconvened at 7:30 p.m., a proposed draft merger agreement was distributed for the first time to Eastern's directors.

In addition, Merrill Lynch reviewed the proposed transaction with the directors.

72. Merrill Lynch refused to render a fairness opinion that took into account the effect of substantial ALPA and TWU wage concessions -- concessions which provided over $200 million in savings to Eastern.

73. Salomon Brothers Inc. ("Salomon"), retained to act as the financial adviser to Eastern's outside directors, refused to issue any fairness option at that time. However Salomon representatives advised the Board that a $10 price might be in the lower range of fairness, but that cost savings from the agreement reached with ALPA and cost savings from other agreements that might be made would increase the value of the Company.

74. The meeting was adjourned again, and reconvened at 10:30 p.m. Defendant Fallon, Chairman of Eastern's Executive Committee, reported on the negotiations with Texas Air. Legal counsel Turner, in response to director concerns, then reported that Texas Air had agreed, among other things, to provide $35 million of indemnification to Eastern's directors in connection with their approval of the merger, and to extend the acceptance deadline to 4:00 A.M.

75. During the adjournment, IAM, the only union with substantial time (some 20 months) remaining on its existing contract, indicated to two directors that while it was not willing to reopen its contract, it was willing to take other cost-saving steps. The directors indicated that another 15% in savings would be sufficient. The Board was advised by the IAM that such savings were assured if Borman were replaced as Chief Executive Officer of Eastern. Even though these savings would have provided the Board (in combination with the agreed-to ALPA and TWU concessions) with everything it had sought to keep Eastern independent, this proposal was rejected in order not to embarrass Borman. The Board then recessed.

76. Borman failed to reveal, and the Board did not appreciate that, in light of the labor concessions which had been agreed to by ALPA and TWU, bankruptcy was no longer (if it ever was) an unavoidable alternative to a shotgun marriage with Texas Air. In a press release to be issued by Eastern upon acceptance by Texas Air, Eastern's general counsel perpetuated the deception, stating that the IAM "would not agree to consider any cost relief for the airline whatsoever," and that the only alternative to the Texas Air deal would have been a Chapter 11 bankruptcy filing. These statements were made despite the clear record that the IAM had given assurance of "cost relief," and that a bankruptcy filing would not have been necessary in light of the other unions' concessions.

77. At 2:25 a.m., the Board reconvened and a majority of the Board, armed with the personal blandishments proposed by Texas Air and acting out of self-interest and a desire to entrench Borman and other members of Eastern's management in their positions, or similar positions with Texas Air, approved the merger between Texas Air and Eastern. Later that day, Eastern and Texas Air executed an Agreement and Plan of Merger dated February 24, 1986

(the "Merger Agreement"). In their haste, the defendant directors failed to fully inform themselves of the information necessary to make an informed decision and therefore violated the fiduciary duty of care. The Board approved the Merger Agreement without reviewing any of the valuation documents distributed by Merrill Lynch at the February 23 meeting; without seeing the final document; without requesting or obtaining a more relevant valuation report or any additional fairness opinions; without any discussion of the purpose or effect of the $20 million inducement fee, Texas Air's "purchase" of 10.9 million newly issued Eastern shares, the lock-up option, the no-shop provision, the quality of the junk bonds to be issued by Eastern, the adequacy of merger consideration, or the intrinsic value of the company; and without seeking to determine whether a higher price could be obtained for the company from its employees or others, and whether the Texas Air proposal was the best way to maximize value to the shareholders.

78. On February 26, 1986, at a joint news conference with Lorenzo to announce the Merger Agreement, Borman publicly admitted that the effect of the Texas Air proposal would be to entrench him and other members of Eastern's management. Specifically, Borman conceded that he and Lorenzo had reached an "understanding" that he and other members of Eastern management would remain entrenched in their positions in control of Eastern following the merger:

> "Let's be candid," Mr. Borman remarked at one point during the news conference, "Mr. Lorenzo and I have an understanding."
>
> Eastern, he said, would be a subsidiary. "It will be operated as a separate entity with management in place," Mr. Borman said.

N.Y. Times, Feb. 26, 1986, at D1, col. 3.

79. Texas Air moved rapidly to assume de facto control of Eastern. Personnel from Texas Air assumed key positions prior to DOT approval. Further, planning and operational decisions were made in Texas Air's best interest and to the detriment of Eastern.

The Texas Air Merger Agreement

80. The financial terms of the Merger Agreement are as follows:

✓ (a) Eastern agreed to sell to Texas Air, and has sold, 10,935,000 shares of common stock at a stated price of $6.25 per share - $3.13 per share to be paid in cash and $3.12 per share to be paid by a 14.125% promissory note due in 1991. As part of the Merger Agreement, Eastern also agreed to (and did) pay to Texas Air a non-refundable "inducement fee" of $20 million. Thus, at the closing of this transaction, a $34.2 million check was written to Eastern by Texas Air, and a $20 million check was written to Texas Air by Eastern, resulting in a net payment to Eastern for the 10,935,000 shares of $14.2 million, or approximately $1.30 per share. The "inducement fee" was actually a thinly veiled arrangement whereby Eastern virtually gave away 18 1/2% of its stock.

(b) Texas Air agreed to purchase Eastern's outstanding common stock for a per share price of $6.25 in cash --

$4.50 per share from Texas Air and $1.75 per share from Eastern, plus $3.75 per share principal amount of a new 11.36% cumulative junior preferred stock of Eastern. The market value of the convertible preferred will be substantially less than $3.75.

81. Eastern granted to Texas Air an irrevocable option (the "Lock-Up Option") to purchase an additional 10 million shares, or approximately 17% of the shares outstanding, at a price equal to $7.50 per share. The option would be triggered in the event that, among other things, any person or group, other than Texas Air, acquired more than 5% of Eastern's outstanding shares. Moreover, Texas Air would have the right to purchase shares in the open market, provided that its total holdings, including the option shares, did not exceed 51% of the total number of shares outstanding. The Lock-Up Option was later amended to allow Texas Air to purchase up to the lesser of 10,000,000 shares or that number of shares which would enable Texas Air to own up to 51% of the voting power of Eastern of authorized but unissued common stock at a price of $7.50 per share through December 31, 1986, or through April 30, 1987 under certain circumstances. Texas Air was, therefore, by virtue of the Merger Agreement, assured of being able to acquire a majority voting interest in Eastern.

82. Eastern also agreed to a provision which negated any possibility of an auction for Eastern's stock, despite the knowledge of Frank Borman and the Board that Eastern employees were interested in buying Eastern. This provision (the "No-Shop

Provision") sets forth Eastern's agreement that neither the company nor any of its officers shall solicit or encourage any offer to acquire the business and properties or capital stock of Eastern or disclose any information not customarily disclosed to the public concerning Eastern to a prospective buyer, or afford access to Eastern's books or records or otherwise negotiate with, facilitate, encourage or assist any person preparing to make or who has made an offer, or to enter into any agreement with any third party providing for a business combination, equity investment or sale of a significant portion of Eastern's assets.

83. The net effect of these arrangements is to abrogate the right of Eastern's other shareholders to vote on Texas Air's proposed merger and to place that right solely in the hands of Texas Air. Under the provisions of Eastern's Certificate of Incorporation, a proposed business combination involving Eastern ordinarily must be approved by the affirmative vote of at least 80% of the stock entitled to vote with respect to the transaction, and at least 50% of the stock not held by a "controlling shareholder," i.e., the beneficial owner of at least 20% of the company's stock. However, a merger proposal accepted by two-thirds of Eastern's directors before the offeror became a "controlling shareholder" need be approved by only 51% of the outstanding shares of Eastern common stock. Thus, Texas Air's merger proposal, approved before Texas Air became a "controlling shareholder," was structured so that Texas Air would be assured the ability to secure approval of the merger, even if every single Eastern shareholder other than Texas Air voted to reject it.

84. Texas Air agreed to honor "golden parachutes" approved by Eastern's Board on January 15, 1986 for 21 officers of Eastern. These agreements provide that if, within two years after a "change in control" of Eastern, their employment is terminated for any reason other than "cause" or on account of death, disability or normal retirement, they are entitled to payments of three (3) times the sum of such officers' (i) highest compensation in effect during the twelve month period preceding such termination, and (ii) the highest annual bonus awarded to such officer during the twenty four months ended on the date of such termination. Such payments would also be payable if the officers' duties and responsibilities are substantially reduced. These golden parachutes range in amount from a high of $684,000 to a low of $216,144 based upon current compensation, for a maximum total amount of $7,347,900. In addition, such agreements provide for cashing out of the officers' stock options and for continuation for up to three years of their life insurance, medical and dental benefits, and the retention by such officers of their pass privileges for flying on Eastern.

85. The inadequacy of the financial terms of the Texas Air merger was immediately recognized by the stock market. The market price of Texas Air's common stood at $16/share on February 20, 1986 (immediately before the Board directed commencement of merger negotiations) and at $27 3/4/share, on March 3, 1986 (one week after the announcement of the merger), a 70.77% increase in Texas Air's market value, attributable only to marketplace

recognition that Eastern was transferring valuable assets to Texas Air at a fire sale price, at the expense of Eastern and its shareholders.

Effect of No-Shop Provision and Lock-Up Option

86. Eastern's Directors followed a course of action and embraced a Merger Agreement which effectively thwarted the possibility of there being any auction for Eastern. Having contacted only one potential buyer with a specific request for a bid, the Board then proceeded to enter into an agreement with that buyer - Texas Air - which on its face and in effect precludes the Board from seeking other bidders, assisting in any way other bidders, or agreeing to the terms of any other bid.

87. On at least three separate occasions, Plaintiff Bryan has sought to obtain for the Eastern employees an opportunity to negotiate for the purchase of Eastern. On each occasion, the Board has refused to even discuss such a purchase with this known willing buyer, due to the Texas Air agreement. The occasions were as follows:

(a) During the negotiations with Texas Air, Mr. Bryan asked for the opportunity to make a bid for Eastern, which request was rejected.

(b) On August 29, 1986, Mr. Bryan proposed to Eastern that the Eastern employees be provided an opportunity to purchase Eastern for $10.25 per share. Eastern refused to pursue the matter with Mr. Bryan on the grounds of the prohibition contained in the No-Shop Provision, despite the fact that the indicated offer was significantly superior to the Texas Air offer.

(c) Again, on October 16, 1986, Mr. Bryan asked the Board to agree to give "serious consideration to any proposal for the acquisition of Eastern . . . presented to the Board on behalf of Eastern . . . employees within the next sixty days." Relying upon the No-Shop Provision, the Board of Directors refused to adopt Mr. Bryan's resolution.

88. The No-Shop Provision and Lock-Up Option and adherence to such clauses by the Eastern Board have resulted in a failure to maximize the company's value at a sale for the shareholders' benefit.

89. The continued adherence to the No-Shop Provision by the Board has resulted in the self-imposed inability of the Board to consider whether the Texas Air offer is fair in light of current circumstances in the industry, including a generally higher fare structure and the pending elimination of People Express as a major low-fare competitor in many of Eastern's markets, which will occur upon Texas Air's acquisition of People Express.

90. The Eastern Board has also precluded its own consideration of the increased value of Eastern based upon: (1) labor costs which the Eastern employees as buyers of Eastern would have within their own control; (2) actual financial results for the second and third quarters of 1986 and current projections.

91. Ignoring the Eastern employees' desire to bid for Eastern, Eastern's Board then embarked upon a course of action

which has wasted corporate assets, to the benefit of Texas Air. Specifically, it has taken the following actions:

(a) Eastern has sold to Pan Am certain of its landing rights at New York's LaGuardia Airport and Washington's National Airport, prior to consummation of the merger, in response to the Department of Transportation's ("DOT") concerns regarding the elimination of competition in Eastern seaboard "shuttle" routes resulting from the common ownership of competitors New York Air and Eastern which would result from a Texas Air acquisition of Eastern. This sale of valuable assets (Eastern has retained certain reversion rights subject to DOT approval) occurred despite the knowledge of Eastern's Board that the No-Shop Provision and Lock-Up Option were unenforceable under Delaware law and that at least one other bidder -- the employees -- whose purchase of Eastern would not raise competitive concerns, was prepared to offer shareholders more for their stock than Texas Air;

(b) Approved the sale by Eastern to Texas Air of a DC-10-30 at a price below the price which would have been obtained for that aircraft in an arms-length transaction;

(c) Allowed Texas Air to buy Eastern stock on the open market at a lower price than would otherwise have been available, because the No-Shop Provision and Lock-Up Option lessened the prospects of a bidding war for Eastern.

(d) Amended the merger agreement to permit Texas Air to acquire 51% of Eastern common stock through open market purchases rather than investing new capital in Eastern by buying the "Lock-Up" amounts from Eastern.

(e) Making premature operational changes in anticipation of a combination with Texas Air units, including modifications to its computer systems, and elimination of a Miami-London route.

The Coalition Corp. Offers

92. By letter dated November 18, 1986, plaintiff Coalition Corp. offered to acquire Eastern in a transaction in which the common stockholders of Eastern would receive net $11.50 per share, in cash, for each share of common stock. Previously, on November 10, 1986, Coalition Corp. had offered to pay $10.25 in cash per share of common stock. The Coalition Corp. offer of November 18 is significantly superior to the terms of the Texas Air merger.

93. On information and belief, the Merger Agreement was filed with the Secretary of State of Delaware on November 25, 1986, thus consummating the merger, upon the vote being taken on the merger at the Special Eastern Stockholder's Meeting of that date.

Count I

(Brought by Plaintiffs Hastings-Murtagh, Murtagh
and Schulte against all defendants under
Section 14(a) of the Securities Exchange
Act of 1934 and SEC Rule 14a-9 thereunder)

94. Plaintiffs reallege and repeat the allegations of paragraphs 1 through 93 above.

Class Action Allegations

95. Plaintiffs Hastings-Murtagh, Murtagh and Schulte bring this action on their own behalf and as a class action pursuant to Rule 23(b)(1), (b)(2), and (b)(3) of the Federal Rules of Civil Procedure on behalf of all employee owners of Eastern's common stock (except defendants herein, members of their immediate families, and any person, firm, trust, corporation, or other entity related to or affiliated with any of the defendants) and their successors in interest who have been deprived of the full value of their equity interest in Eastern by reason of the Texas Air merger which was accomplished through the unlawful acts described herein.

96. The class is so numerous that joinder of all members is impracticable. The number and identity of the members of the class can be ascertained from the books and the records of the company and/or its agents. The members of the class are scattered throughout the United States.

97. There are questions of law and fact common to the class, which questions predominate over questions that affect only individual members of the class. The common questions include, inter alia:

(a) whether the defendants breached their fiduciary duties to the class by approving Eastern's entering into the Merger Agreement with Texas Air;

(b) whether the Lock-Up Option granted to Texas Air and the No-Shop Provision are illegal;

(c) whether defendants breached their fiduciary duties to the class by virtue of Eastern's sale of shares and options to Texas Air, their grant of the Lock-Up Option, their agreement to and their adherence to the No-Shop Provision, and their payment of the $20,000,000 inducement fee;

(d) whether defendants breached their fiduciary duty to the class by willfully and wrongfully failing to negotiate with Coalition Corp., a known willing buyer, for the sale of Eastern at a higher price than obtained from Texas Air;

(e) whether the defendants violated the employee-common stock holders' preemptive rights to purchase Eastern's common stock and other equity-related securties when Eastern sold newly-issued common stock and options to Texas Air pursuant to sections 9.1 and 9.2 of the merger agreement;

(f) whether defendants breached their fiduciary duties to the class by virtue of their receipt of and acquiescence in the golden parachutes granted to certain Eastern management personnel;

(g) whether defendants' Proxy Materials sent to the class violated Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9 thereunder;

(h) whether Defendants breached their fiduciary duty to the employee-common stockholder class as a distinct constituency of common stockholders and

known willing buyers to whom the Board owed distinct duties of care and loyalty.

(i) The special fiduciary duty owed by the Directors to the employee-shareholders arises from the following historical facts:

(j) In 1973, there were several major trunk airlines including Eastern, American, United, TWA, Delta, Northwest, and Pan American, among others. All were relatively healthy financially.

(k) The combination of a recession and the OPEC-generated fuel cost crisis faced these airlines with severe cost problems. Rather than stockpile cash, which is essential to airline operations in difficult financial times, Eastern increased its indebtedness due to poor management decisions.

(l) In 1979 when U.S. airlines were deregulated, Eastern's excessive indebtedness left it ill-equipped to deal with so-called "up-start" airlines which acquired used aircraft and cheap labor (cheap because the labor pool was young, with minimal financial responsibilities) and offered air travel at cut-rate prices. Eastern's indebtedness continued to mount, because of continuing cash shortages and further management mistakes.

(m) To alleviate said excessive indebtedness, Eastern turned to its employees for concessions, causing them to literally pay for management's mistakes.

(n) All airline employees in the U.S. and elsewhere are vertically "locked in" to their respective companies; that is, a pilot, machinist or flight attendant who has achieved seniority and favorable rates of compensation with one airline cannot find work with another airline without starting at the bottom of the scale, no matter what his or her experience level. Eastern's management knew and exploited this fact.

(o) Over a period of ten years, Eastern's employees have contributed over nine hundred million dollars to Eastern's financial mistakes.

(p) Eastern's employee shareholders received shares not because they were ready, willing, able but not forced to buy those shares as was the case with other investor-shareholders, but because they were given no choice; due to its mistakes, management had no currency with which to make a competitive payroll, only stock certificates.

(q) Both Eastern's management and its Board knew that the employee-shareholders had agreed to accept stock in order to preserve in operating condition a benefit to them which could never be attained in any other fashion: Seniority and appropriate pay scales in a professional career to which all of these employee-shareholders had devoted most of their adult lives.

(r) In view of the incontrovertible facts set forth above, it was particularly unconscionable for Eastern's management and its Board to secretly seek a buyer whose peculiar business practices would be anathema to professionals so committed to their careers, and who would inevitably destroy the Eastern Airlines they had given so much to preserve.

98. Plaintiffs' claims are typical of the claims of the class and plaintiffs will fairly and adequately protect the interests of the class.

99. The likelihood that individual members of the class will prosecute separate individual actions is remote due to the burden and expense of prosecuting individual litigations of this nature and magnitude. There will not be any difficulty in the management of this litigation.

100. A class action is superior to other available methods for the fair and efficient adjudication of the controversy, and the requirements of Rule 23 of the Federal Rules of Civil Procedure are satisfied.

101. The conduct of defendants as set forth herein, as well as in other regards, was in violation of Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 14a-9 thereunder in that the acts, conduct and transactions refer-

red to herein (a) operated as a fraud upon plaintiffs; (b) made various untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading to the plaintiff; and (c) constituted manipulative acts or courses of conduct.

102. On or about October 20, 1986, defendants caused a certain Notice of Special Meeting of Stockholders to be held on November 25, 1986 ("Meeting") and a Proxy Statement-Prospectus dated October 15, 1986 together with a letter to Eastern's Common Stockholders from its President dated October 14, 1986, Supplement No. 1 and a letter from Merrill Lynch to Eastern's Florida Stockholders dated October 15, 1986, and prior to the Meeting, Supplements No. 2, 3 and 4 ("Proxy Materials") to be sent through the United States mails to Eastern's stockholders. The Proxy Materials were some 500 pages in length and solicited the stockholders' proxies to vote in favor of the Merger Agreement, Special Charter Amendments and Preferred Stock Amendments.

103. The Proxy Materials informed the stockholders that the favorable vote (by proxy or otherwise) of a majority of the outstanding shares of common stock was necessary to ratify the Merger Agreement and that Texas Air beneficially owned some 36.3 million of the shares of common stock, constituting 50.3% of the outstanding common stock. The said Proxy Materials further informed the stockholders that Eastern and Texas Air believe that stockholder approval of the Merger is assured; and that, on October 17, 1986,

Eastern's Board of Directors elected Lorenzo as Chairman of the Board and Bakes as President and Chief Executive Officer of Eastern and Lorenzo and Bakes were elected to the Board of Directors of Eastern.

104. By virtue of its extreme length, complexity of transactions and numerous matters submitted for stockholder vote, the Proxy Materials were intended to be beyond the understanding of the average Eastern stockholder, failed to highlight the most important facts to be considered by stockholders in deciding how to vote on the Merger proposal, and obfuscated the true nature of the transactions to be considered by the stockholders by scattering related information throughout the Proxy Materials, such as failing to state the dollar value of the inducement fee while disclosing the dollar value of the simultaneous payment by Texas Air when discussing the sale of 10,935,000 shares of common stock pursuant to Section 9.1 of the Merger Agreement.

105. The Proxy Materials omitted to state at least the following material facts as required by law:

(a) Purchases of Eastern's common stock by Texas Air since Texas Air became an affiliate of Eastern on February 24, 1986 as required by Item 1(f) of Schedule 13E-3, of Rule 13e-3, including the amount of such securities purchased, the range of prices paid and the average price for each quarterly period.

(b) The source of the $108.7 million of funds of Texas Air to be used in the Merger if Eastern does not obtain sufficient consents from holders of Eastern's Debentures, as required by Item 6(a) of Schedule 13E-3 of Rule 13e-3.

(c) The excess of the liquidation value of Eastern's assets over their book value, highlighting the "off-balance sheet" assets.

(d) That the principal purpose for the Merger was to acquire Eastern for the advantage of Texas Air and to the detriment of Eastern's employee-shareholders for much less than its true value, and to do so with Eastern's own borrowing power, cash flow and assets.

(e) That newly-issued shares of Eastern's common stock and options sold to Texas Air pursuant to Sections 9.1 and 9.2 of the Merger Agreement violated pre-emptive rights to purchase common stock and other equity-related securities held by employees of TWU, ALPA and IAM as trust beneficiaries through their WIP trust.

(f) That Bryan had delivered by messenger a certain letter dated February 7, 1986 from Bryan to Borman, the Chief Executive Officer of Eastern, pursuant to which Bryan suggested that Eastern allow employees to voluntarily convert debt of Eastern (approximately $50,000,000 of Investment Bonus Agreement funds) to newly issued Eastern common stock at the market price to increase stockholders equity and tangible net worth of Eastern.

(g) That a representative of Salomon Brothers, investment bankers retained by the outside directors, stated, at the February 23, 1986 meeting of Eastern's directors that

Salomon's preliminary opinion was that a price of $10 per share "might be in the lower range of fairness".

(h) That the outside directors of Eastern refused to approve the Merger Agreement in light of the refusal of Salomon Brothers to express an opinion regarding the fairness of the offer to Eastern's stockholders at the February 23 Board meeting until Texas Air provided such directors with indemnification against liability arising from the Merger of $35 million, subject to a $5 million deductible.

(i) That Eastern's filing for protection under Chapter 11 of the Federal Bankruptcy Code was no longer an unavoidable alternative after two of the three unions agreed to the concessions sought by management, prior to approval of the Merger Agreement on February 24, 1986.

(j) That a change of control of Eastern occurred since January 1, 1986, as required by Item 5(f) of Schedule 14A of Regulation 14A and Item 403(c) of Regulation S-K.

(k) That the way that defendants had structured the Merger effectively foreclosed any other purchasers from making a higher offer for Eastern or for Eastern's stock, and that defendants refused to consider and took active steps to discourage other offers.

(l) That the Lock-Up Option contained in Section 9.2 of the Merger Agreement is unenforceable under Delaware law.

(m) That the indemnification of Eastern's directors by Texas Air up to a maximum of $35,000,000, subject to a

$5,000,000 deductible, in connection with the approval and implementation of the Merger Agreement, is unenforceable under the federal securities laws.

(n) That the No-Shop Provision contained in Section 6.5 of the Merger Agreement is unenforceable under Delaware law, and, therefore, the Board was obligated to seek alternative offers to purchase Eastern.

(o) The contingent liability and securities law violationsof Texas Air due to the fact that Texas Air, in conjunction with Jet Capital Corporation and their wholly-owned subsidiaries, purchased and sold Eastern's common stock from January 22, 1986 to February 26, 1986 while in possession of material non-public information about Eastern, on the grounds that:

(i) Texas Air's Schedule 13D filed on March 6, 1986 with the Securities and Exchange Commission sets forth such purchases and sales in Appendix II thereto.

(ii) The Proxy Materials of Texas Air and Eastern admit at pp. 23-24 thereto that, during December, 1985, Texas Air was supplied by Eastern with material non-public information about Eastern, including (i) that Borman had met Lorenzo to discuss the possibility of a Texas Air offer for Eastern and (ii) projections of Eastern's estimated income (loss) and revenues and expenses for the 1985-86

period.

106. The Proxy Materials untruthfully stated that at the February 23 meeting of the Board there were recesses to deliberate, when, in fact, there were merely several adjournments.

107. The Proxy Materials misleadingly stated that "it appeared to the Directors that, unless agreement could be reached with all three principal unions, default under Eastern's loan agreements was a certainty..." Any default would have been only technical and easily waived, as in fact occurred in this case.

108. The Proxy Materials as in the past misled the Eastern's stockholders regarding the seriousness of the employees as an alternative purchaser (i) by referring to their coalition in quotation marks in Supplement No. 1 and the Proxy Materials (ii) by misquoting Bryan's oral offer of October 17, 1986 discussed in the Supplement No. 1 by changing his statement from the employees being "very" serious to "pretty" serious about the resolution and the proposals, and (iii) by omitting to state the history of the Employees' efforts to purchase Eastern and their purchases of Eastern stock, as more fully described, inter alia in paragraphs 47-53 herein.

109. All of the untrue statements referred to in paragraphs 106 through 108 were of material facts. Each of the facts alleged in paragraph 97 to have been omitted from the Proxy Materials was a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. The cumulative effect of such omissions

and untruthful statements was to make the Proxy Materials pervasively misleading and deceptive.

110. Defendants acted with such reckless disregard for the truth that they failed or refused to ascertain and disclose such facts as would reveal the materially false and misleading nature of the statements made, although such facts were readily available to defendants. Said acts or omissions of defendants were committed willfully or with reckless disregard for the truth. In addition, each defendant knew or recklessly disregarded that material facts were being misrepresented or omitted as described above.

111. Plaintiffs Hastings-Murtagh, Murtagh and Schulte have been, and, absent this Court's relief, will continue to be, irreparably harmed by defendants' conduct in that Eastern shareholders had inadequate information on which to base their vote on the Texas Air proposal.

112. Plaintiffs have no adequate remedy at law for the injuries caused by defendants' unlawful conduct.

113. An actual controversy exists between plaintiffs and defendants.

WHEREFORE, plaintiffs respectfully demand judgment against defendants as follows:

(i) Unwinding the merger of Eastern and TAC/EAL Acquisition, Inc.

(ii) Upon unwinding the Merger, permanently enjoining the defendant directors, Texas Air, TAC/EAL

Acquisition Corp., their agents, employees, and anyone acting on their behalf or in concert with them from (a) performing under the Lock-Up Option, (b) taking any other steps whose purpose or effect is to hinder the ability of any third party to make an offer for Eastern; (c) voting the shares acquired from Eastern pursuant to the Merger Agreement and any other shares acquired by Texas Air or TAC/EAL Acquisition Corp. on or subsequent to December 4, 1985, in favor of the proposed merger; or (d) taking any steps to consummate the Merger Agreement;

(iii) Declaring this action a class action;

(iv) In the alternative, awarding the class compensatory damages, if the Texas Air merger is not unwound;

(v) Awarding plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees;

(vi) Granting such other and further relief as this Court deems just and proper; and

(vii) Trial by jury on all issues so triable.

Count II

(Brought by Plaintiffs Hastings-Murtagh, Murtagh, and Schulte against the director defendants, defendants Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp. for breaches of fiduciary duties)

114. Plaintiffs reallege and repeat the allegations of

paragraphs 1 through 93 above.

115. Plaintiffs reallege and repeat the class action allegations of paragraphs 95 through 100.

116. The action of Borman and the director defendants in entering into the Merger Agreement and precluding other potential offers was a breach of their fiduciary duty and the duty of care and loyalty, was grossly negligent, and was improper under the Delaware General Corporation Law ("DGCL"), in at least the following respects:

(a) Eastern management failed to approach employee leaders who represented Eastern's largest shareholder regarding an employee purchase of Eastern;

(b) Defendant directors failed to obtain an up-to-date valuation based upon realistic and achievable assumptions and instead relied upon a dated valuation based upon assumptions which resulted in an unrealistically low valuation of the company;

(c) Defendant directors acceded to the condition of Texas Air that the merger be negotiated during a two-day weekend period, most of which had been consumed before the matter even came before the Board, which deadline was wholly artificial and a coercive device of Texas Air to enable it to purchase Eastern at less than fair value, and which led to the directors' reliance on inadequate information regarding the intrinsic value of the company and the fairness of the transaction to Eastern shareholders;

(d) Defendant directors agreed to the Lock-Up Option and No-Shop Provisions demanded by Texas Air, which effectively precluded other bids which might have resulted in a higher price to Texas Air, including the bid which Eastern's employees consistently sought to make;

(e) Defendant directors have adhered to the No-Shop Provision in the face of knowledge that a bidder existed whose bid would be higher than the Texas Air bid, thus blatantly violating their obligation to obtain the highest price possible for the benefit of the shareholders;

117. Defendant directors breached their fiduciary duties to Eastern and its shareholders and improperly manipulated Eastern's corporate machinery by guaranteeing Texas Air the ability to acquire 51% of Eastern's outstanding common stock, sufficient to compel shareholder approval of the Merger Agreement without the affirmative vote of any non-Texas Air shareholders. By agreeing to and facilitating this improper lock-up of the proposed transaction, the defendant directors deprived Eastern shareholders of their fundamental right to approve or disapprove proposed business combinations involving Eastern and reduced the requirement of shareholder approval to a sham. Moreover, the defendant directors further breached their fiduciary duties to Eastern and its shareholders and manipulated Eastern's corporate machinery by arrogating solely to themselves the decision whether to approve the proposed business combination of Eastern and Texas Air.

118. The defendant directors breached their duty of loyalty to Eastern and its shareholders by improperly accepting

personal perquisites as an inducement to approve the Merger Agreement. The defendant directors finally approved the Merger Agreement only after Texas Air had agreed to indemnify the defendant directors for their breach of fiduciary duty in approving the agreement.

119. The defendant directors further breached their duty of loyalty to Eastern and its shareholders by placing their loyalty to defendant Borman and Eastern management above their loyalty to Eastern and its shareholders. The defendant directors rejected consideration of valuable cost savings offered by IAM only because those real savings were conditioned on an eventual transition of Eastern management. Moreover, as admitted by Borman, the Merger Agreement was approved based on an "understanding" between Borman and Lorenzo that Borman and Eastern management would remain entrenched in their positions at Eastern or at similar positions at Texas Air following the merger.

120. The defendant directors breached their duty of care to Eastern and its shareholders by improperly delegating their responsibilities to the executive committee of the Board.

121. Defendants Texas Air, TAC/EAL Acquisition Corp., and current directors Lorenzo and Bakes aided and abetted and conspired in the defendant directors' breaches of fiduciary duty by:

(i) Stampeding the defendant directors into a hasty and uninformed decision to approve the Texas Air Merger Agreement by imposing an artificial 48-hour deadline on

acceptance of the proposed agreement;

(ii) Precluding the defendant directors from soliciting or approving other offers for Eastern which might provide adequate consideration to Eastern shareholders;

(iii) Insisting on a non-refundable $20 million "inducement fee" which could be used to purchase Eastern stock;

(iv) Importuning the defendant directors to accept blandishments, including personal indemnification, director benefits in order to obtain approval of Texas Air's inadequate offer;

(v) Further inducing the defendant directors to breach their duty of loyalty by offering an "understanding" with Borman and Eastern management that they would remain entrenched in their positions at Eastern or Texas Air following the proposed merger; and

(vi) Requiring the defendant directors to manipulat Eastern's corporate machinery to lock-up Texas Air's proposed merger with Eastern and reduce shareholder approval to a sham.

122. By taking the above actions, Texas Air became an active participant in the defendant directors' breaches of fiduciary duty ~~and~~ knowingly reaped the benefits of those breaches of fiduciary duty.

123. Plaintiffs Hastings-Murtagh, Murtagh and Schulte have been, and, absent this Court's relief, will continue to be, irreparably harmed by defendants' conduct in that:

(a) Eastern shareholders have been denied their fundamental right to approve or disapprove the Texas Air merger due to the defendants' manipulation of Eastern's corporate machinery:

(b) Other bidders, and especially Coalition Corp., have been precluded from competing on a fair and equal basis for control of Eastern; and

(c) Eastern shareholders have been denied the opportunity to obtain adequate consideration for their shares; and

124. Plaintiffs have no adequate remedy at law for the injuries caused by defendants' unlawful conduct.

125. An actual controversy exists between plaintiffs and defendants.

WHEREFORE, plaintiffs respectfully demand judgment against defendants as follows:

(i) Unwinding the merger of Eastern and TAC/EAL Acquisition, Inc.;

(ii) ordering the Eastern Board to in good faith consider the pending offer of Coalition Corp. and any other offers to acquire Eastern.

(iii) Declaring that the No-Shop Provision is null, void, invalid and unenforceable;

(iv) Declaring that the Lock-Up Option granted to Texas Air is null, void, invalid and unenforceable;

(v) Cancelling the $20 million "inducement fee" granted to Texas Air and imposing a constructive trust on any such fees paid to Texas Air for the benefit of Eastern and its shareholders;

(vi) Upon unwinding the Merger, permanently enjoining the defendant directors, Texas Air, TAC/EAL Acquisition Corp., their agents, employees, and anyone acting on their behalf or in concert with them from (a) performing under the Lock-Up Option, (b) taking any other steps whose purpose or effect is to hinder the ability of any third party to make an offer for Eastern; (c) voting the shares acquired from Eastern pursuant to the Merger Agreement and any other shares acquired by Texas Air or TAC/EAL Acquisition Corp. on or subsequent to December 4, 1985, in favor of the proposed merger; or (d) taking any steps to consummate the Merger Agreement;

(vii) Declaring that after the Texas Air merger is unwound, if it is again presented for stockholders vote, it must be approved by the vote of at least 80% of the Eastern stock entitled to vote with respect thereto, and at least 50% of the shares not controlled by Texas Air;

(viii) Ordering divestiture and rescission of any Eastern stock issued by Eastern pursuant to the Merger Agreement;

(ix) Declaring this action a class action;

(x) In the alternative, awarding the class compensatory damages, if the Texas Air merger is not unwound;

(xi) Awarding plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees;

(xii) Granting such other and further relief as this Court deems just and proper; and

(xiii) Trial by jury on all issues so triable.

Count III

(Brought by Plaintiffs Hastings-Murtagh, Murtagh, and Schulte against the director defendants, Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp., for waste of corporate assets and gross negligence)

126. Plaintiffs reallege and repeat the allegations of paragraphs 1 through 93 above.

127. Plaintiffs reallege and repeat the class action allegations of paragraphs 95 through 100.

128. The payment by Eastern of golden parachute payments to officers, including some of the defendant directors, is without a proper or apparent corporate purpose, constitutes a waste of assets and is grossly negligent.

129. The payment by Eastern of a $20 million "inducement fee" to Texas Air to enter into the Merger Agreement is without a proper corporate purpose, constitutes a waste of assets and is grossly negligent.

130. The issuance to Texas Air of 10,935,000 shares of Eastern common stock for insufficient consideration is without a proper corporate purpose, constitutes a waste of assets and is grossly negligent. Although nominally requiring Texas Air to pay the sum of $6.25 per share for the stock, its real cost was only $1.30 per share, because the defendant directors agreed to pay Texas Air a $20 million "inducement fee" upon consummation of the stock purchase, and to finance $3.12 of the amount through a promissory note not due until 1991, thus providing Texas Air with Eastern funds with which to purchase the Eastern stock.

131. The sale by Eastern of certain gates and landing rights to Pan Am in order to obtain DOT approval of the Texas Air merger, which sale was made prior to consummation of the Merger Agreement and with the knowledge that there was another bidder prepared to offer a higher price for Eastern's stock whose bid the Board had a legal obligation to consider and whose acquisition of Eastern would not raise competitive concerns, is without a proper or apparent corporate purpose, constitutes a waste of assets and is grossly negligent.

132. Defendants Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp. aided and conspired in the wasteful and negligent acts of director defendants described above.

133. Plaintiffs Hastings-Murtagh, Murtagh and Schulte have been, and, absent this Court's relief, will continue to be, irreparably harmed by Defendants' conduct in that: Eastern's directors and management will continue to waste corporate assets and engage in other actions which constitute gross negligence.

WHEREFORE, Plaintiffs respectfully demand judgment against Defendants as follows:

(i) Permanently enjoining Eastern, its directors, officers and agents, from wasting the assets of Eastern, including paying any amounts due under "golden parachute" agreements, and the transferring of aircraft, gates, landing rights, or other assets, except for fair value and except to parties other than Texas Air, People Express or any subsidiaries or affiliates thereof;

(ii) Declaring this action a class action;

(iii) In the alternatyive, awarding the class compensatory damages, if the Texas Air merger is not unwound;

(iv) Awarding Plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees;

(v) Granting such other and further relief as this Court deems just and proper; and

(vi) Trial by jury on all issues so triable.

Count IV

(By Plaintiffs Hastings-Murtagh, Murtagh, and Schulte against the director defendants, defendants Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp. under Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9 thereunder)

134. Plaintiffs reallege and repeat the allegations of paragraphs 1 to 93 and 101 through 110 above.)

SERVICE LIST

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135. Plaintiffs Hastings-Murtagh, Murtagh and Schulte also bring this action on their own behalf and on behalf of a class of similarly situated 20% Participating Non-Cumulative Convertible Preferred (20% Participating Preferred") stockholders of Eastern to recover damages suffered as a result of the acceptance by the Eastern Board of the inadequate Texas Air offer; to unwind the merger with Texas Air; to invalidate the Merger Agreement, including the inducement fee, the No-Shop Provision, the Lock-Up Option, and Texas Air's purchases of Eastern stock, all of which were approved by the defendant Directors in violation of their fiduciary obligations and Delaware law; and to direct the Eastern Board after unwinding of the Texas Air merger to in good faith consider the pending offer of plaintiff Coalition Corp., which offer is clearly superior to the Texas Air offer and is in the best interests of all Eastern shareholders.

Class Action Allegations

136. Plaintiffs Hastings-Murtagh, Murtagh and Schulte bring this action on their own behalf and as a class action pursuant to Rule 23 (b)(1), (b)(2) and (b)(3) of the Federal Rules of Civil Procedure on behalf of all owners of Eastern Air 20% Participating Preferred Stockholders (except defendants herein, members of their immediate families, and any person, firm, trust, corporation, or other entity related to or affiliated with any of the defendants) and their successors in interest who have been deprived of the full value of their equity interest in Eastern by reason of the Texas Air merger which was accomplished through the unlawful acts described herein.

137. The class is so numerous that joinder of all members is impracticable. The number and identity of the members of the class can be ascertained from the books and the records of the company and/or its agents. The members of the class are scattered throughout the United States.

138. There are questions of law and fact common to the class, which questions predominate over questions that affect only individual members of the class. The common questions include, inter alia:

(a) whether the defendants breached their fiduciary duties to the class by approving the entering into the Merger Agreement with Texas Air;

(b) whether the transfer of Eastern's assets to Texas Air's subsidiaries or affiliates, the combined use of Eastern's SystemOne computer reservations system by Texas Air affiliates and pooling of Eastern's spare parts and materials with those of Texas Air and its affiliates have been in the best interests of Eastern and Eastern's 20% Participating Preferred stockholders. (c) whether defendants breached their fiduciary duties to the class by virtue of Eastern's sale of shares and options to Texas Air, their grant of the Lock-Up Option, their agreement to and their adherence to the No-Shop Provision, and their payment of the $20,000,000 inducement fee;

(d) whether defendants breached their fiduciary duty by willfully and wrongfully failing to negotiate with Coalition Corp., a known willing buyer, for purchase of Eastern at a higher price than obtained from Texas Air;

(e) whether defendants breached their fiduciary duties to the class by virtue of their receipt of and acquiescence in the golden parachutes granted to certain Eastern management personnel; and

(f) whether defendants' Proxy Materials sent to the class violated Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9 thereunder.

(g) whether defendants violated the 20% Participating Preferred stockholders' preemptive rights to purchase common stock and other equity-related securities of Eastern when Eastern sold newly issued common stock and options to Texas Air pursuant to sections 9.1 and 9.2 of the Merger Agreement.

139. Plaintiffs' claims are typical of the claims of the class and plaintiffs will fairly and adequately protect the interests of the class.

140. The likelihood that individual members of the class will prosecute separate individual actions is remote due to the burden and expense of prosecuting individual litigations of this nature and magnitude. There will not be any difficulty in the management of this litigation.

141. A class action is superior to other available methods for the fair and efficient adjudication of the controversy, and the requirements of Rule 23 of the Federal Rules of Civil Procedure are satisfied.

142. Plaintiffs Hastings-Murtagh, Murtagh and Schulte have been, and, absent this Court's relief, will continue to be, irreparably harmed by defendants' conduct in that:

(a) Other bidders, and especially Coalition Corp., have been precluded from competing on a fair and equal basis for control of Eastern;

(b) Eastern shareholders have been denied the opportunity to obtain adequate consideration for their shares; and

143. Plaintiffs have no adequate remedy at law for the injuries caused by defendants' unlawful conduct.

144. An actual controversy exists between plaintiffs and defendants.

WHEREFORE, plaintiffs respectfully demand judgment against defendants as follows:

(i) Unwinding the merger of Eastern and TAC/EAL Acquisition, Inc.

(ii) Upon unwinding the Merger, permanently enjoining the defendant directors, Texas Air, TAC/EAL Acquisition Corp., their agents, employees, and anyone acting on their behalf or in concert with them from (a) performing under the Lock-Up Option, (b) taking any other steps whose purpose or effect is to hinder the ability of any third party to make an offer for Eastern; (c) voting the shares acquired from Eastern pursuant to the Merger Agreement and any other shares acquired by Texas Air or TAC/EAL Acquisition Corp. on or subsequent to December 4, 1985, in favor of the proposed merger; or (d) taking any steps to consummate the Merger Agreement;

(iii) Ordering divestiture and rescission of any Eastern stock issued by Eastern pursuant to the Merger Agreement;

(iv) Declaring this action a class action;

(v) In the alternative, awarding the class compensatory damages, if the Texas Air merger is not unwound;

(vi) Awarding plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees;

(vii) Granting such other and further relief as this Court deems just and proper; and

(viii) Trial by jury on all issues so triable.

Count V

(By Plaintiffs Hastings-Murtagh, Murtagh,
and Schulte against the director
defendants, defendants Texas Air, Lorenzo, Bakes, and
TAC/EAL Acquisition Corp. for breaches of fiduciary duties)

145. Plaintiffs reallege and repeat the allegations of paragraphs 1 to 93.

146. Plaintiffs reallege the class action allegations of paragraphs 136 through 141 above.

147. Plaintiffs Hastings-Murtagh, Murtagh and Schulte have been, and, absent this Court's relief, will continue to be, irreparably harmed by defendants' conduct in that:

(a) Other bidders, and especially Coalition Corp., have been precluded from competing on a fair and equal basis for control of Eastern;

(b) Eastern shareholders have been denied the opportunity to obtain adequate consideration for their shares; and

148. Plaintiffs have no adequate remedy at law for the injuries caused by defendants' unlawful conduct.

149. An actual controversy exists between plaintiffs and defendants.

WHEREFORE, plaintiffs respectfully demand judgment against defendants as follows:

(i) Unwinding the merger of Eastern and TAC/EAL Acquisition, Inc.;

(ii) ordering the Eastern Board to in good faith consider the pending offer of Coalition Corp. and any other offers to acquire Eastern.

(iii) Declaring that the No-Shop Provision is null, void, invalid and unenforceable;

(iv) Declaring that the Lock-Up Option granted to Texas Air is null, void, invalid and unenforceable;

(v) Cancelling the $20 million "inducement fee" granted to Texas Air and imposing a constructive trust on any such fees paid to Texas Air for the benefit of Eastern and its shareholders;

(vi) Upon unwinding the Merger, permanently enjoining the defendant directors, Texas Air, TAC/EAL Acquisition Corp., their agents, employees, and anyone acting on their behalf or in concert with them from (a) performing under the Lock-Up Option, (b) taking any other steps whose purpose or effect is to hinder the ability of any third party to make an offer for Eastern; (c) voting the shares acquired from Eastern pursuant to the Merger Agreement and any other shares acquired by Texas Air or TAC/EAL Acquisition Corp. on or subsequent to December 4, 1985, in favor of the proposed merger; or (d) taking any steps to consummate the Merger Agreement;

(vii) Declaring that after the Texas Air merger is unwound, if it is again presented for stockholders vote, it must be approved by the vote of at least 80% of the Eastern stock entitled to vote with respect thereto, and at least 50% of the shares not controlled by Texas Air;

(viii) Ordering divestiture and rescission of any Eastern stock issued by Eastern pursuant to the

Merger Agreement;

(ix) Declaring this action a class action;

(x) In the alternative, awarding the class compensatory damages, if the Texas Air merger is not unwound;

(xi) Awarding plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees;

(xii) Granting such other and further relief as this Court deems just and proper; and

(xiii) Trial by jury on all issues so triable.

Count VI

(By Plaintiffs Hastings-Murtagh, Murtagh,
and Schulte derivatively on behalf of Eastern
against the director defendants, defendants Texas Air,
Lorenzo, Bakes, and TAC/EAL Acquisition Corp.
for waste of corporate assets and gross negligence)

150. Plaintiffs reallege and repeat the allegations of paragraphs 1 to 93.

151. Since the merger, the transfer of any of Eastern's assets and improper pooling of such assets to Continental Airlines, New York Air or any other affiliate of Texas Air, is without a proper or apparent corporate purpose, constitutes a waste of assets and is grossly negligent.

152. No demand has been made on Eastern's Board to bring this action, and demand is excused in these circumstances for the following reasons:

(a) A majority of Eastern's Board has been designated by Texas Air pursuant to the merger agreement or the current Board of Directors of Eastern is otherwise under the control and influence of Texas Air; and Texas Air is the sole common stockholder of Eastern.

(b) The pattern of conduct alleged above, including the Board's persistent refusal to cooperate in any way with Eastern employees in connection with an acquisition effort which the employees were clearly able and prepared to make -- and have subsequently made -- upon terms superior to those offered by Texas Air, repeated warnings to Plaintiff Bryan to cease any activity inconsistent with the No-Shop provision, the unrelenting hostility of certain Board members to certain leaders of Eastern's employees, make it apparent that any demand made would be futile.

153. Plaintiffs Hastings-Murtagh, Murtagh and Schulte have been, and, absent this Court's relief, will continue to be, irreparably harmed by defendants' conduct in that Eastern directors and management will continue to waste corporate assets and commit acts of gross negligence:

154. Plaintiffs have no adequate remedy at law for the injuries caused by defendants' unlawful conduct.

155. An actual controversy exists between plaintiffs and defendants.

WHEREFORE, plaintiffs respectfully demand judgment against defendants as follows:

(i) Permanently enjoining Eastern, its directors, officers and agents from wasting the assets

of Eastern, including paying any amounts due under "golden parachute" agreements, and the transferring of gates, landing rights, aircraft or other assets, except for fair value and except to parties other than Texas Air, TAC/EAL Acquisition Corp., or People Express, or any subsidiaries or affiliates thereof;

(ii) Awarding plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees;

(iii) Granting such other and further relief as this Court deems just and proper; and

(iv) Trial by jury on all issues so triable.

Count VII

(By Plaintiffs Coalition Corp., Bryan and Callahan
against the director defendants
Texas Air, Lorenzo, Bakes, and TAC/EAL Acquisition Corp.)

156. Plaintiffs reallege and repeat the allegations of paragraphs 1 through 93 above.

157. Because of the defendants' actions as alleged in this complaint, and the specific violations of law alleged in Counts I-IV, potential competing bidders, including Plaintiff Coalition Corp. and its shareholders, have been effectively prevented from bidding to acquire Eastern and obtaining good faith consideration of any such bid. In the case of plaintiff Coalition Corp., this has occurred despite the fact that the terms of its offers provide for substantially greater compensation to Eastern stockholders than offered by Texas Air. The

following actions of defendants, among other actions, have prevented such competing bids from being made and considered:

(a) the Board's agreement to the No-Shop Provision, its adherence to such provision and its failure to acknowledge the unenforceability of such provision;

(b) the Board's agreement to the Lock-Up Option and its sale of 10,935,000 common shares to Texas Air;

(c) the securities law violations detailed in Count I; and

(d) the Board's breaches of fiduciary duty and acts of waste and negligence as detailed in Counts II and III above, and the actions of Texas Air, Lorenzo, Bakes and TAC/EAL Acquisition Corp. in aiding and abetting such violations of laws.

158. Plaintiff Coalition Corp. is owned and controlled, and was formed, by the employee unions (ALPA, TWU, and IAM) to bring the existing coalition of employees having a common interest in acquiring Eastern under a single entity. Since early 1986, these employees have acted in concert with the same objective as is now manifested and formalized under the vehicle of Coalition Corp., namely, to acquire Eastern. On the foregoing basis, and as a direct and proximate result of the acts of Defendants alleged herein, the Coalition Corp. has been prevented from having their offers to purchase Eastern considered by the Board of Directors, and has suffered damages as herein alleged.

159. Plaintiffs Coalition Corp., Bryan, and Callahan

have been, and, absent this Court's relief, will continue to be, irreparably harmed by defendants' conduct in that Coalition Corp. has been precluded from competing on a fair and equal basis for control of Eastern;

160. Plaintiffs have no adequate remedy at law for the injuries caused by defendants' unlawful conduct.

161. An actual controversy exists between plaintiffs and defendants.

WHEREFORE, plaintiffs Coalition Corp., Bryan and Callahan respectfully demand judgment against defendants as follows:

(i) Unwinding the merger of Eastern and TAC/EAL Acquisition, Inc. and ordering the Eastern Board to in good faith consider the pending offer of Coalition Corp. and any other offers to acquire Eastern.

(ii) Declaring that the No-Shop Provision is null, void, invalid and unenforceable;

(iii) Declaring that the Lock-Up Option granted to Texas Air is null, void, invalid and unenforceable;

(iv) Cancelling the $20 million "inducement fee" granted to Texas Air and imposing a constructive trust on any such fees paid to Texas Air for the benefit of Eastern and its shareholders;

(v) Upon unwinding the Merger, permanently enjoining the defendant directors, Texas Air, TAC/EAL Acquisition Corp., their agents, employees, and anyone acting on their behalf or in concert with them from (a) performing under the Lock-Up Option, (b) taking any other steps whose purpose or effect is to hinder the ability of any third party to make an offer for Eastern; (c) voting the shares acquired from Eastern pursuant to the Merger Agreement and any other shares acquired by Texas Air or TAC/EAL Acquisition Corp. on or subsequent to December 4, 1985, in favor of the proposed merger; or (d) taking any steps to consummate the Merger Agreement;

(vi) Permanently enjoining Eastern, its directors, officers and agents from wasting the assets of Eastern, including paying any amounts due under "golden parachute" agreements, and the transferring of gates, landing rights, aircraft or other assets, except for fair value and except to parties other than Texas Air, TAC/EAL Acquisition Corp., or People Express, or any subsidiaries or affiliates thereof;

(vii) Declaring that after the Texas Air merger is unwound, if it is again presented for stockholders vote, it must be approved by the vote of at least 80% of the Eastern stock entitled to vote with respect thereto, and at least 50% of the shares not controlled by Texas Air;

(viii) Ordering divestiture and rescission of any Eastern stock issued by Eastern pursuant to the Merger Agreement;

(ix) Awarding plaintiffs their costs and disbursements incurred in connection with this action, including reasonable attorneys' fees;

(x) Granting such other and further relief as this Court deems just and proper; and

(xi) Trial by jury on all issues so triable.

Elizabeth A. Hastings-Murtagh,
Daniel P. Murtagh, E.A.L. Employee
Coalition Acquisition Corp., an
Illinois corporation, Charles E.
Bryan, Robert V. Callahan and Larry
Schultz

By: Don Beverly
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VERIFICATION

STATE OF FLORIDA)
) SS
COUNTY OF PALM BEACH)

CHARLES E. BRYAN states on oath that: I am one of the plaintiffs herein; I have read the attached First Amended Verified Complaint for Declaratory and Injunctive Relief; and the factual matters alleged in such Complaint are true and correct to the best of my knowledge and belief.

Charles E Bry

Signed and sworn to before me
on December 8, 1986

Mary M. Dumark
Notary Public

Notary Public, State Of Florida At Large
My Commission Expires Aug. 15, 1989
[illegible]

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing First Amended Verified Complaint has been furnished to counsel of record by U.S. Mail or Federal Express as indicated on the attached service list, this 8th day of December 1986.

BEVERLY & FREEMAN

823 North Olive Avenue
West Palm Beach, Florida 33401
(305) 655-6022

By
DON BEVERLY

SERVICE LIST

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EXHIBIT E

Roland M. Attenborough, Inc.

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ROLAND M. ATTENBOROUGH
[illegible]

TELEPHONE
(213) 277-[illegible]

October 22, 1986

MEMORANDUM

TO: All Interested Persons

FROM: Roland M. Attenborough

RE: Proposed Acquisition of Eastern Air Lines, Inc. by Texas Air Corporation

The purpose of this Memorandum is to describe the principal features of the proposed acquisition of Eastern Air Lines, Inc. ("Eastern") by Texas Air Corporation ("Texas Air") as they relate to the employees and shareholders of Eastern. The source of the details is Eastern's Proxy Statement - Prospectus, the Merger Agreement and financial statements of the two companies.

The proposed acquisition will involve the payment to the common shareholders of Eastern of $6.25 per share in cash - ($4.50 per share from Texas Air and $1.75 per share from Eastern) - plus $3.75 per share principal amount of a new 11.36% cumulative junior preferred stock of Eastern. Dividends and redemption and liquidation preferences of the new Eastern preferred stock will be guaranteed by Texas Air on a subordinated basis. Eastern would become a wholly-owned subsidiary of Texas Air.

1. The Board of Directors of Eastern agreed not to consider any offer for the Company from anyone - even at a higher price than offered by Texas Air.

The Merger Agreement provides that Eastern shall not negotiate with, encourage or cooperate with any person who is preparing to make or has made an offer to acquire the Company. This provision, in effect, prohibits Eastern from even considering a higher offer for the Company.

The first contact of Texas Air by Eastern was authorized by Eastern's Executive Committee on February 14, 1986. A special meeting of Eastern's Board of Directors was called on Friday, February 21, 1986. Negotiations with

Texas Air during that weekend resulted in the Merger Agreement in the early hours (about 2:45 A. M.) on Monday, February 24, 1986. No consideration was given to possible alternative offers by the employees or anyone else to purchase Eastern. Yet, the entire deal, involving over $600 million was negotiated and agreed to in about 1 to 2 days.

On August 29, 1986, Charles E. Bryan, a director of Eastern, submitted to the Eastern Board of Directors a proposal to permit the employees of Eastern to purchase Eastern at $10.25 per share. Relying on the provision in the Merger Agreement prohibiting negotiations for competing offers, the Eastern Executive Committee rejected Mr. Bryan's proposal on September 2, 1986.

2. The Eastern Board of Directors sold 10,935,000 shares of common stock to Texas Air on terms which, in effect, cost Texas Air only $1.30 per share.

Under the Merger Agreement, Texas Air bought 10,935,000 shares of common stock from Eastern at $6.25 per share - $3.13 per share to be paid in cash and $3.12 per share to be paid by a 14.15% promissory note due in 1991. Thus, $34.2 million was to be paid in cash and $34.1 million was paid with a promissory note that would not be due until 1991 - long after Texas Air would already own all of Eastern.

As part of the Merger Agreement, Eastern agreed to (and did on March 3, 1986) pay to Texas Air an "inducement fee" of $20 million - i.e. to induce Texas Air to agree to the Merger Agreement.

As a result of the payment terms for the 10,935,000 shares and the $20 million inducement fee, Texas Air will have paid only $14.1 million - or $1.30 per share.

3. The Eastern Board of Directors gave Texas Air an option to buy enough shares of Eastern common stock to insure that Texas Air would own 51% of the Eastern common stock.

Under the Merger Agreement, Eastern gave to Texas Air an irrevocable option to purchase up to 10,000,000 shares of common stock of Eastern at $7.50 per share. An amendment to the Merger Agreement, dated May 7, 1986, changed the number of shares covered by the option to the lesser of (1) 10,000,000 shares, or (2) that number of shares which would enable Texas Air to own up to 51% of the voting power of Eastern. The option may be exercised through December 31, 1986 - or through April 30, 1987 under certain circumstances.

The effect of this stock option is to give to Texas Air the assurance that it can acquire 51% of the voting power of Eastern and thus ensure approval of the acquisition - under circumstances where the Board of Directors has refused to consider alternative offers which would have resulted in a higher price to the public and employee shareholders.

4. The combination of Texas Air, Eastern, and People Express will be so highly leveraged that it is doubtful that it can survive without going through a Chapter 11 Bankruptcy proceeding.

The pro forma balance sheet of the combined entities as of June 30, 1986 shows total assets of $7.7 billion and liabilities and redeemable preferred stock of $7.1 billion, leaving $600 million in equity. Of the $7.1 billion, $5.3 billion is attributable to long-term debt, capitalized lease obligations and redeemable preferred stock, which results in a debt - to - equity ratio of 8.8 to 1. In addition, the interest expense attributable to the debt is estimated at $588 million per year. Thus, interest expense alone represents 7.4% of the operating revenues of the combined entities on an annualized basis.

The pro forma income statement of the combined entities shows that for the six months ended on June 30, 1986, there would be a loss of $409 million. Projecting these losses beyond that date indicate that the entire net worth of the combined entities would be eliminated in approximately 9 months.

The combination of operating losses and the enormous debt service requirements due to the acquisition of Eastern and People Express will make it impossible for Texas Air to continue without a major reorganization. In 1983, after the acquisition of Continental Airlines by Texas Air, Continental was put through a Chapter 11 bankruptcy proceeding - the result of which was that the union contracts were rejected and Continental's employees are now working for substantially reduced compensation, in some cases less than half of their previous levels. Aside from a Chapter 11 proceeding, resulting in the rejection of existing union contracts and substantial reduction in employees' salaries and wages, there appears to be no way for Texas Air to satisfy the enormous debt service requirements connected with the acquisition of Eastern and People Express.

5. The new Eastern 11.36% Preferred stock ($3.75 per share of the Eastern common stock) has questionable value and the Texas Air guarantee may have no practical effect.

Although the dividend on the new Eastern 11.36% preferred stock is cumulative, the dividend may be paid by Eastern issuing additional shares of that stock. In addition, dividend rights on all other classes of preferred stock of Eastern must be paid before any cash dividend on the 11.36% preferred stock can be paid. In view of the cash requirements described above, it is doubtful that any cash would be available for dividends at any point in the foreseeable future.

Eastern is required to begin redeeming the 11.36% preferred stock after 6 years according to a schedule that would result in 40% of the stock being redeemed in 10 years. The remaining 60% of the stock has to be redeemed at the end of 10 years. The estimated amount involved will be approximately $135 million plus dividends.

Texas Air has agreed to guarantee the dividend and redemption payments on a subordinated basis. As to dividends, Eastern will be able to satisfy the dividend requirements simply by issuing additional shares of the 11.36% preferred stock without the holders of such stock receiving any cash whatsoever. As to the redemption requirements, the Texas Air guarantee is subordinated to all of its senior debt - which, as of June 30, 1986, totaled $1.47 billion. In the event of default by Texas Air as to any of its senior debt, no payments could be made under the guarantee.

6. The assets of Eastern are being used by Texas Air to finance the acquisition.

Pursuant to the Merger Agreement, Eastern will pay $1.75 per share of the cash portion of the price, which will total approximately $109 million. An additional $130 million will be paid by Eastern to its preferred shareholders and investment banks and for other costs related to the acquisition. In addition, Eastern will issue approximately $233 million of its 11.36% preferred stock. Thus, $472 million of the total cost of the acquisition will have been paid for by Eastern.

The Merger Agreement provides that the cash of $1.75 per share to be paid by Eastern and the $3.75 per share of 11.36% preferred stock to be issued by Eastern are not to be paid or issued to Texas Air or to any wholly-owned subsidiary of Texas Air. However, the Proxy Statement discloses that Texas Air may transfer most of its Eastern stock to a 99% owned subsidiary, in which case, cash of $44 million and $95 million of 11.36% preferred stock of Eastern would be paid to Texas Air.

To finance the acquisition, Eastern will obtain a new loan of $500 million, with interest rates ranging from 11-3/4% to 13-3/4%, and secured by trust certificates on aircraft presently owned by Eastern. Of the $500 million, $120 million will be used to repay existing debt and the balance of $380 million will be used to pay the acquisition cost and for such other purposes as Eastern and Texas Air determine.

7. Texas Air has given the members of Eastern's Board of Directors a $35,000,000 indemnification agreement to cover any breach of fiduciary or other duties by the Eastern board.

Under the Merger Agreement, Texas Air has agreed to indemnify the members of the Eastern Board of Directors for any loss incurred by them in connection with the approval or implementation of the Merger Agreement. Said indemnification would cover any breach of fiduciary or other duty of the directors to the Eastern shareholders or employees. It covers claims of up to $35,000,000 per year for a 2 year period, with a $5,000,000 deductible during each 1 year period.

When the Merger Agreement was being negotiated with Texas Air over the weekend of February 22-23, 1986, the outside directors of Eastern had previously engaged the investment banking firm, Saloman Brothers Inc., to advise them as to the fairness of any proposed sale of Eastern. Saloman Brothers Inc. declined, at that time, to give such an opinion (although they subsequently did, on September 11, 1986, give such an opinion). It is reasonable to conclude that the speed with which the Merger Agreement was being pushed through, combined with the Saloman Brothers Inc. position, gave those directors enough concern for their own personal liability that they insisted upon this indemnification.

8. Prior to the Merger Agreement, Eastern entered into lucrative "golden parachute" agreements with 21 of the officers of Eastern.

On January 15, 1986, the Eastern Board of Directors approved severance agreements - known as "golden parachutes" - with 21 of the officers of Eastern. These agreements provide that if, within 2 years after a "change in control" of Eastern, their employment is terminated for any reason other than "cause" or on account of death, disability or normal retirement, they are entitled to payments of three (3) times the sum of such officers' (i) highest compensation in effect during the 12 month period preceding such termination, and (ii) the highest annual bonus awarded to such officer during the 24 months ended on the date of such termination. Such payments would also be payable if the officers duties and responsibilities are substantially reduced, etc.

Based upon the current compensation of the 21 officers, the payments would range from a high of $684,000 to a low of $216,144 - and the maximum total amount of all such payments would be $7,347,900.

In addition, such agreements provide for cashing out of the officers' stock options and for continuation for up to 3 years of their life insurance, medical and dental benefits. Also, such officers would retain their pass privileges for flying on Eastern.

EXHIBIT F

DISCUSSION PAPER

IMPACT ANALYSIS OF PROPOSED
INCOME REDUCTIONS AT EASTERN AIRLINES

February, 1987

Center for Labor Research & Studies
Florida International University
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(305) 554-2371 • State University System

IMPACT ANALYSIS OF PROPOSED
INCOME REDUCTIONS AT EASTERN AIRLINES

February, 1987

Prepared by:

D. Marshall Barry, Ph.D.
Director of Applied Research

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Director, Center for Labor
Research & Studies

FLORIDA INTERNATIONAL UNIVERSITY

SUMMARY OF INCOME REDUCTIONS PROPOSED BY
FRANK LORENZO AND TEXAS AIR CORPORATION
ON THE EMPLOYEES OF EASTERN AIRLINES

Part I: Introduction and Purpose of Report

In its Press Release of January 21, "Eastern Airlines Highlights Corporate Plans for 1987", Eastern Airlines outlined its plans for what it described as "Labor Cost Restructuring." The details, to the extent that they have been released, are as follows:

1. A reduction in the labor costs of Mechanics, Loaders, Custodians, and related maintenance classifications of $265 million below the current level of earnings by these workers.

2. A reduction in the labor costs of Flight Attendants of $69 million below the level of current earnings by these workers.

3. A reduction in the labor costs of Pilots of $113 million below the level of current earnings by these workers.

4. A reduction in labor costs of $43 million by early retirement of workers currently employed.

In total, Eastern Air Lines is demanding a reduction in the earnings of its workers of $490 million, or 28.8 percent, according to press reports and company information. This " Labor Cost Restructuring" is necessitated, according to press and company sources, in order to make Eastern more competitive with the other airline companies. As stated by the newly installed President, Philip Bakes, and reported in the Wall Street Journal of January 22, 1987, "Our labor-cost structure is a cancer. ...The employees don't like the medicine, but they know it has to be taken." In short, as of January 22, 1987, the problem and the solution were presented to the employees, press, and public as quite simple: The employees, if they would accept a 28.8 percent cut in their wages and benefits, would make Eastern competitive.

The media carried this simple message to the public as a conventional wisdom. To the public, especially Miami's residents, the message has a familiar sound. For years the "medicine" to make Eastern healthy has been beyond management's reach. This time, however, new management offered new hope for growth and health. All that is needed is cooperation from the employees and the understanding that this time management means business.

In table form, the proposed cuts to Eastern employee remuneration by its Texas Air owners are as follows:

Affected Workers	Current Costs	Proposed Costs	Demanded Cut	Percent of Cuts
Mechanics, Loaders, Custodians, etc.	$566m	$301m	$265m	46.8%
Flight Attendants	$221m	$152m	$ 69m	31.2%
Pilots	$417	$304m	$113	27.3%

Early retirement savings: $43 million

TOTALS OF TEXAS AIR DEMANDS ON EASTERN EMPLOYEES' REMUNERATION:

Reductions in wages and benefits:	$490 million
Percentage reduction proposed:	28.8%

Even though the Eastern bargaining unit contracts are in force and not set for renegotiation until next year, Frank Lorenzo,the driving force behind Texas Air Corporation - the number one airline company in the United States since his acquisitions of of Eastern, Continental, People Express, and New York Air - has communicated the message that the employees have little choice in the matter. The 28.8% reduction can achieved by either layoffs or cuts in wages and benefits, or both. As reported in the Wall Street Journal of January 22, 1987, " ...Texas Air has sources of leverage at its disposal. It could switch Eastern's assets into Texas Air's non-union operations, or launch sweeping layoffs at Eastern to induce union leaders into renegotiating their contracts. ... The company chose to keep workers guessing. 'We have Plans, ... but we aren't prepared to discuss them,'" stated the newly installed Eastern president.

Prior to the announcement by the company of the proposed 28.8 percent cuts in worker remuneration, Eastern had already begun to exert leverage by such actions as banning union officials from its properties and, as reported in the Journal, firing Flight Attendants " ...for alleged work - rule infractions at a rate six times greater than in pre - Texas air days. The time required to resolve union grievances, which only recently was several weeks, has grown to a full year."

The apparent clarity of purpose of Texas Air's Frank Lorenzo in his proposed cutting of Eastern's employee wages and benefits by 28.8 percent was muddled by his actions of the following week. On January 30, 1987 the press reported that Texas Air had slashed fares as much as 40 percent below "supersaver" fares on all of its routes, including those of Eastern. As reported in the Wall Street Journal of January 30, 1987, "Continental will offer the new discounts on 40% of its seats, and Eastern will sell 10% to 20% of its seats at the new discount. ... The fare discounts on Eastern flights was a particular surprise as Eastern's first quarter traffic is usually stronger than the industry average because of vacationers traveling to Florida. 'I don't understand it. ... How they can justify this with Eastern, I have no idea,'" said Louis Marckesano, analyst for Janney Montgomery Scott. "With high-cost Eastern struggling with heavy losses, 'they are taking away whatever cushion they had.' "

The purpose of this Report is to analyze the local impact in Miami of such significant layoffs or wage/benefits cuts. We find that the total impact of such a drastic decision by Texas Air upon the Miami economy would extend far beyond the reduced level of earnings and ability to spend of affected Eastern employees in the local market. The magnitude of the economic impact of this proposed exogenous shock must be measured so that members of the community not directly employed by Eastern will be aware of the full burden this Texas Air decision will have on their own economic status. With such dramatic cutbacks, there is the distinct possibility that community goals are not compatible with corporate ones. Even if Eastern, i.e. Texas Air, becomes more profitable, it may accomplish this by exerting a negative force in the level of Miami's income and employment. In short, Texas Air profitability and further airline industry monopolization by Frank Lorenzo may attain corporate business objectives while creating a major economic recession in Miami. Whether corporate successes yield economic stability and growth for the citizens of Dade County and Southeastern Florida is the key question addressed in this Report.

Further, this Report will analyze and attempt to resolve the paradoxical behavior of Frank Lorenzo's proposal to cut labor costs at Eastern by 28.8% to make the firm more competitive while at the same time initiating a dramatic price war. As stated, Frank Lorenzo has slashed the fares charged by Texas Air and its subsidiaries (including Eastern) by as much as 40 percent. The question of why the number one carrier, Texas Air, cuts its fares to such an extent one week after it emphatically proclaimed the overriding necessity to reduce the costs of employee wages and benefits deserves careful investigation. Why would a successful business man make these two apparently contradictory decisions within one week of each other? The validity of the view expressed by one airline observer that all Frank Lorenzo has to do to make Eastern a profitable company is to make a phone call to himself needs to be examined. This Report will examine these question as well.

Part II: The Economic Impact on Miami of the Texas Air Demands

The impact on the employment levels and economic well-offness of the Dade County area of the demands by Texas Air will extend far beyond the ranks of Eastern's employees. As Eastern employees suffer cutbacks, layoffs, or both in order to placate the corporate needs of Texas Air, they will be forced to adjust their expenditures and consumption to meet their drastically reduced levels of income. For example, a machinist's family facing a 46.8 percent cut in total income would have to reduce expenditures to a level of about one-half the previous level. Such a cut means reduced sales and income for all the businesses with which they formerly traded. Many of these former expenditures would have to be discontinued altogether as the affected families found themselves with little more than enough to meet their payments on past purchases, mortgages on their homes, and basic necessities such as food. This process can be easily envisioned by imagining the extent to which one's own life would be changed if existing income were reduced by approximately one-half of its current level.

Subsequently, the business and professional communities whose sales to the former Eastern employees have been curtailed have to adjust to their own lowered economic state. In order to compensate for the losses they experienced, businesses will have to cut back on both employees and on orders from their suppliers. These in turn will also adjust to their new economic condition by cutting back on their purchases of goods and services, including labor. In short, Texas Air's corporate decisions will have negative spread and ripple effects throughout the Miami area. Considering the size of the proposed cut-backs, nearly every Miami citizen will be adversely affected.

Economists have developed a tool to estimate the total impact of such cut-backs after these waves of deleterious consumption reductions have run their course. This concept is called the "income multiplier" and provides an easy estimator of the total negative effect in a locality. The Income Multiplier, calculated from historical data, is approximately 2.4 for Dade County. Quite simply, a local income multiplier of 2.4 means that for every dollar of reduced income in the area, there will be a total reduction of area income of $2.40 by the time the second and subsequent rounds of adjustments to the initial cut in income have run their course. In other words, every cut of $1.00 in Eastern employees' income by Texas Air will eventually lead to a $2.40 reduction in income for the residents of Miami.

Using this economic concept, the total economic impact on Miami of the Texas Air decisions can be calculated as follows:

MIAMI AREA NEGATIVE IMPACT OF TEXAS AIR INCOME REDUCTIONS:

Miami Area Employees Only:	MIAMI AREA CUTS	TOTAL LOCAL IMPACT
Mechanics, Loaders, et.al.	$114 million	$273.6 million
Flight Attendants	$ 24 million	$ 57.6 million
Pilots	$ 29 million	$ 69.6 million
Early retirement	$ 14 million	$ 33.6 million
TOTALS:	$180 million	$434.4 million

Frank Lorenzo's corporate decision will actually exert a greater negative impact on area individuals and families not directly associated with his Texas Air holdings than on the affected employees. As shown in the following:

Negative Impact On Eastern Employees in Miami:	$181 million
Negative Impact On Non-Eastern Residents in Miami:	$253.4 million
Total Negative Impact on Everyone's income in Miami:	$434.4 million

Even though Texas Air is advertising these cuts as being directed against the employees of Eastern, the negative impact of its takeover of Eastern as a subsidiary on the rest of Miami will be 140 percent as great as the burden on Eastern employees. The local economy will be inflicted with a $434.4 million reduction in income in order for Texas Air to improve its operating profit by $161 million in reduced wages and benefits to local employees. This $434.4 million is the true cost to the community of Frank Lorenzo's take-over of Eastern and his subsequent "Labor Cost Restructuring."

CONCLUSION: The cuts in remuneration demanded by Frank Lorenzo from the employees of Eastern Airlines in the Miami area amount to $181 million. After the multiple effect from this initial shock to the local economy has occurred, the total reduction in area incomes will be approximately $434.4 million, or 2.4 times as great as the Texas Air reduction. Non-Eastern employees will bear the brunt of these reductions.

While the multiple, adverse effect on area incomes would be 2.4 times as great as Texas Air's savings with either layoffs or wage/benefit rollbacks, the impact on various sectors of the local economy would differ. With wage-cut demands averaging 28.8 percent, the burden imposed by Texas Air on Miami would be severe, but more evenly distributed. All sectors of the economy would be impacted. Naturally, the Retail Trade sector would be damaged because residents would be forced to reduce purchases of non-essential goods and services. Especially impacted would be the consumer durable markets of appliances, automobiles, furniture and other similar items. Non-essential expenditures on entertainment, restaurants, clothes, travel, etc. would be curtailed. Construction of new housing as well as purchases of existing units would be reduced.

With layoffs of an average of 28.8 percent of the local labor force at Eastern, the sectoral impact would differ. The layoffs required by Texas Air's "Labor Cost Restructuring" would equal approximately 4,800 personnel, including Miami based Flight Attendants, Pilots, Mechanics, Loaders, Custodians, and non-bargaining unit personnel. With 4,800 families deprived of all, or a major source of their income, there would be a dramatic impact on the Finance, Insurance, and Real Estate sectors of the local economy. A significant increase in defaults on home mortgages and bank loans for consumer purchases of automobiles and other consumer durables would result. Abandonment of existing contractural obligations would be a necessity for the unemployed workers. The local rate of personal as well as business bankruptcies would rise. Health insurance expenditures would drop with concurrent personal and family exposure to risk. Naturally there would be a liability to the taxpayers as the number of cases with an inability- to- pay increased at Jackson Memorial Hospital.

Because of the non-existence of local employment which utilized the skills and specific investment in the human capital of the affected workers, there would be an emigration of a large number of these families in search of employment elsewhere.

Old Wine in New Bottles: It is insightful to view the "Texas Air " wage demands from the point of view of the historical development of wages and working conditions in the western world. For example, the demand for an immediate 46.8 percent reduction in wages and benefits from the Mechanics, Loaders, Custodians, and related maintenance classifications would reduce the existing levels of remuneration to, or very close to the entry level of wages which currently exists for these classifications. In effect, the Texas Air demands would result in a compression of wages unprecedented in modern times.

In order to find an approximate historical parallel to the proposed compression of the wage structure into a single, entry wage for each classification, Economic history has to be researched back to the end of the eighteenth and into the nineteenth centuries. The concept and practice of making the entry level of wage for a particular work classification or job the only level to be paid to the employees was a common practice in the early industrial revolution. At that time it was common practice for employers to hire and continue to pay employees the entry wage rate only for as long as such workers were able to maintain their levels of productivity. As soon as a worker began to age on the job and/or a younger, more productive employee entered the workforce, the employer replaced the older worker. There was no pay increment or wage spread within such occupations in order to reward an employee for experience, knowledge, or loyalty/reliability gained over time.

Workers were viewed as homogeneous, undifferentiated inputs into the production process which were often discarded when new workers entered the labor force. The insecurity of the average worker was increased significantly because of the absence of child labor laws at that time. Profit maximizing entrepreneurs of that period were quick to utilize children in their factories and other workplaces in order to keep productivity high and costs low. At the turn of the century in this country, the presence of 2 million children in mines and factories while 6 million men were unemployed was justified by the "good" business logic: "why hire a man for a dollar when you can find a kid for a dime."

While being careful to delineate between the past and the present, it is important to note that the humanizing of the work experience in this country involved the changing of the conditions and excesses of the early Industrial Revolution. Over time employers found it to their advantage to reward employees by increasing their wages with experience and longevity. Moreover, these employers began to see the connection between the wages they paid and the ability of their consumers to buy the products they sold. Workers were also consumers, and rising incomes permitted them to buy the products produced by an industrial society. Workers also identified with their jobs in response to the reward of increased pay rates with longevity. In short, the institution of wage spreads within each job classification developed over time and was functional both to the employer and to the worker. The widening of this spread has been an important contributor to the rise in the standard of living in this country.

The commonplace existence of this wage spread within each job classification is documented in the *Area Wage Survey* of the Bureau of Labor Statistics of the U. S. Department of Labor. This survey was conducted for the Miami area in October of 1985 for 38 different job classifications. As shown in the following table, each of these positions has a spread between the starting and maximum rates of pay actually in existence in the Dade County area. These classifications and their spread from start to maximum are as follows:

Job Classification	Entry Weekly Salary Range	Weekly Mean Salary	Weekly Maximum Salary
Secretaries	$160 -180	$346.50	over $540
Typists	180 -200	261.00	460 -480
Word Processors	220 -240	298.00	400 -420
File Clerks	less than 160	194.00	420 -440
Messengers	160 -180	242.00	300 -320
Receptionists	160 -180	221.00	300 -320
Switchboard operator	less than 160	200.00	470 -440
Switchbrd. oper/receptionist	less than 160	220.00	520 -540
Order clerks	less than 160	272.00	440 -460
Accounting clerks	less than 160	276.00	520 -540
Payroll Clerks	less than 160	310.50	520 -540
Key entry operators	160 -180	265.00	440 -460
Computer systems analyst	280 -300	631.00	more than 880
Computer programmers	300 -320	566.50	840 -880
Computer operators	less than 240	341.50	600 -640
Drafters	less than 240	382.00	640 -680
Electronics tech	less than 240	487.50	640 -680

Hourly Earnings of Maintenance, Toolroom, & Powerplant Workers

Maintenance carpenters	$6.00 -6.50/hr.	$7.63/hr.	13.50 -14.00
Maintenance electrician	7.00 -7.50	10.00	14.50 -15.00
Maintenance painter	5.00 -5.25	6.15	10.00 -10.50
Maintenance machinist	7.00 -7.50	10.70	more than 15.00
Maintenance mechanic	6.00 -6.50	11.47	14.50 -15.00
Motor vehicle mechanic	7.50 -8.00	9.79	more than 15.00
Maintenance workers (gen.)	less than 5.00	6.50	12.50 -13.00
Maintenance trades helper	5.00 -5.25	7.45	8.50 -9.00
Machine tool oper.(toolrm)	6.50 -7.00	9.32	11.50 -12.00
Tool and die makers	9.00 -9.50	11.06	14.50 -15.00

Hourly Earnings for Material Movement and Custodial Workers

Truckdrivers	3.50 -4.00	7.61	14.00 -15.00
Shippers	4.00 -4.50	6.78	11.50 -12.00
Receivers	3.50 -4.00	5.75	12.00 -12.50
Shippers and receivers	3.50 -4.00	7.50	11.00 -11.50
Warehouseman	3.35 -3.50	12.70	14.00 -15.00
Order filler	3.50 -4.00	9.00	10.50 -11.00
Shipping packers	3.50 -4.00	5.60	8.00 -8.50
Material handling laborers	3.50 -4.00	5.78	13.00 -13.50
Forklift operators	4.00 -4.50	6.61	13.50 -14.00
Guards	3.35 -3.50	4.78	11.50 -12.00
Janitors, porters, cleaners	3.35 -3.50	4.27	12.50 -13.00

As can be seen in the above table, the existence of spreads in wages paid to each job classification are commonplace and should be considered an institutionalized practice in the American labor markets. In fact, there was not a single job classification surveyed by the Bureau of Labor Statistics of the U.S. Department of Labor for the Miami area for which such a spread did not exist. The attempt by Texas Air to compress the wages paid to Eastern Employees into a single, entry wage cannot be justified by the data on the local labor market. As can be seen by the statistic "Weekly mean salary" in the table, the simple arithmetic average rate of pay is far above the entry rate in all classifications. It is clear that the prevailing and usual practice in payment to employees is to practice the modern policy of rewarding employees for experience, loyalty/dependability and training by granting each employee an opportunity to improve his/her earnings within each job classification.

In order to understand the full impact of the Texas Air Entry Wage Proposal (EWP) on the level of wages and income of workers, it is instructive to take one's own wage classification in the above table and to calculate exactly the impact of having your weekly, or hourly wage rolled back to the entry wage level shown. For example, Secretaries, who earned an average of $346.50 per week and some who earned more than $640 per week would be rolled back to the level at which new secretaries could be hired: $160 to $180 per week. Obviously, the average Secretary would take a 50 percent cut in pay using the Texas Air EWP (entry wage proposal) wage theory. A similar calculation could be made for all of the job classifications and the results would be similar.

Texas Air is demanding similar cuts from its employees at Eastern. Mechanics, loaders, custodians and related maintenance workers at Eastern, although they were not in the Bureau of Labor

Statistics survey, are targated for a 46.8 percent cut in pay. The Pilots at Eastern are currently earning at a rate 20 percent below that of January, 1986. Texas Air is demanding an additional 27.3 percent reduction in labor costs from their membership. Flight Attendants are also currently earning at a level 30 percent less than their earnings in February 1986 due to past concessions. Texas Air is demanding still further concessions amounting to 31 percent from them as well. The past concession by the Flight Attendants of a lower salary schedule for new hirees is being utilized by Texas Air to gain wage reductions from these employees. The practice of drastically increased firings accompanied by the drawing out of the grievance procedure to about one year's delay is the mechanism utilized to accomplish by subterfuge what could not be gained in bargaining. When these past wage concessions are added to the current demands for reductions by Texas Air, Eastern employees are clearly facing the reinstitution of a wage scheme reminiscent of that used by employers in the early Industrial Revolution.

The overall negative impact of the introduction of the Entry Wage Level policy into the Miami area economy can be estimated from the Bureau of Labor Statistics of the Department of Labor survey data provided above. For the job classifications shown, if the mean average wages were compressed to the entry wage level, there would be a reduction in incomes in the local labor market of 40.3 percent. Using the multiplier concept discussed earlier in this paper, the size of the economic downturn which would result is imaginable. If all workers were subject to the same wage theory as is currently being introduced in Eastern, all workers would take a 40 percent cut in incomes on the first round with subsequent expenditure cuts resulting in a total reduction of some 2.4 times as great as the initial cuts. This possibility cannot be dismissed lightly. The larger the pool of unemployed workers who have been dismissed for failure to accept cuts of such magnitude or who have been replaced by a younger worker just entering the workforce, the greater the downward pressure on current wages.

Frank Lorenzo is not the only employer pushing for a dramatic rollback in wages in Miami. The current push for "Privatization" by the cities and counties in Florida is a format by which existing wage spreads in various classifications can be compressed into a single entry wage. As reported in the Sunday edition of the Miami Herald (Neighbors Section, February 1, 1987, pp. 2 and 14), the City of Coral Gables has plans to "farm-out" its golf courses to private companies. The stated advantage was that the private firms " '... would cut costs by not paying the same salaries or benefits,' " according to the Recreation Director. The article continued to note that the City Manager had admonished his department heads: " 'Don't feel that you're safe just because you have a function that looks like it can't be privatized.' " The article continued to state that " ... more and more cities have turned to private enterprise for traditionally public services hoping to have the jobs done cheaper and better." Also it is a good tactic to " ... reduce the strength of employees' union(s)." The plight and powerlessness of the average employee faced with such tactics is well depicted by a maintenance employee of Coral Gables quoted in the Herald article. He stated, "At my age, who's going to hire me after I've been with the Gables 25 years? ... Where can I go to get a job? Nowhere?"

It is doubtful whether the affected Gables employees perceive the similarity of their plight to that of the Eastern employees of the Texas Air Corporation. However, both employers are replacing employees whose earnings reflect past experience and loyalty/reliability with cheap workers earning entry level wages. Both employers would offer existing workers the opportunity to take cuts in their wages and benefits in order to compete with the cheap workers not currently employed. The employees' alternative is to look elsewhere for work. This prospect is not promising, as stated by the Gables maintenance worker, since other employers will also be adopting the Entry Wage Level practice. Once again, as was the case in the early Industrial Revolution, older workers are forced to compete with new entrants in a labor market which places no value on experience or past loyalty.

The most ironic aspect of this attack on the existing institution of wage spreads within each job classification is the changing value it places on "specific investment" in the human capital of our workforce. While all levels of our society exhort workers to become skilled and to take advantage of all available training, the return to the Entry Wage Level past by some employers removes the incentives and rewards to any employee for so doing. In fact, the more specialized a worker has become through training, the more vulnerable he/she is to the Texas Air tactics. For example, a highly trained mechanic, licensed and experienced in the repair and maintenance of jet engines, cannot easily go outside of the airline industry for employment which will utilize his skills. Much of his/her training is specific to the industry in which he/she works. The next best opportunity employment would probably pay far less for his/her services since the ability to repair jet engines is not highly valued in non-airline industries.

The same fact is true for all of the employee groups under attack by Texas Air. For example, Flight attendants are highly trained in the care and protection of passengers on planes - a specific skill not fully transferable to another industry. Airline Pilots and their skill and training are likewise largely "specific" to the airline industry. In all cases the next best "opportunity wage" for these employees would not reward them for the factors which justified their wages and benefits with the airlines.

PART III: THE ECONOMIC MACHINATIONS OF FRANK LORENZO

It is important to analyze the behavior of Texas Air and Frank Lorenzo in their meteoric rise to control of the airline industry. An observer of the industry has commented that "...all Frank Lorenzo has to do to solve the problems at Eastern is to make a phone call to himself." Also noted was Lorenzo's paradoxical behavior of demanding huge cuts from Eastern employee groups in one week as the sine qua non to save the company and initiating a fare war (including up to a 40% cut in fares at Eastern) the following week. These cuts at Eastern coincided with its usually strong first quarter traffic. The question of " How can they justify this with Eastern?" must be answered.

To make sense of Frank Lorenzo's behavior, the observer/analyst must drop the traditional Economic perspective. Frank Lorenzo is anything but traditional in his approach to business. He does not appear interested in running one airline successfully. Rather he wants to acquire enough airlines to control the air travel industry, if only on a regional basis. Lorenzo does not seem to want to maximize profits by minimizing costs, including labor, and maximizing revenue for that one airline. His behavior evidences a willingness to weaken in the short run the condition of a single airline he controls in order to use it as a weapon to lower the costs of all of his airlines in the long run. He clearly is acting to monopolize at least on a regional basis his control of air travel. At the same time he is becoming a monopsony in the purchase of factor inputs, including labor, in the production of air services. When he achieves his monopoly position, where will a Flight Attendant, Pilot, or Mechanic work if these employees reject Lorenzo's Entry Level wages and benefits? He, more than any member of the industry, typlifies the heralded ROBBER BARON of 19th century American Economic history.

Louis Marckesano, analyst for Janney Montgomery Scott (Miami News article by Lore Croghan, February 3, 1987, pp. 1A and 7A), stated that the result of Eastern's achieving the wage reductions would be to "cut standards of living for workers with little benefit to the consumer. Eastern would become highly profitable, but the profitability would be short-lived because other airlines would follow suit. The one who will suffer will be the worker." It appears, however, that Frank Lorenzo is using the cuts in one airline to "whip-saw" the workers in others. It is true that the workers are the ones who are hurt in such a case.

If Texas Air owns or controls these "other" airlines,however, their post-wage-cut profitability need not disappear. Acting like a true monopolist with dramatically lowered costs, Lorenzo could raise fares to the consumer to maximize his own personal profits. In the wake of this business success, he would have left a trail of injured parties. Prominent among these would be Miami area businesses and workers, as well as consumers everywhere.

Conclusion: If Frank Lorenzo can be assumed to be more interested in his long - run position in the industry than in the short - run position of any of the firms he controls, his failure to " place that phone call to himself" makes good business sense.

His treatment of labor have their closest historical parallel to the "pattern bargaining" of the United Auto Workers

Union. Typically, the U. A. W. would choose one auto producer with which to bargain and against which all of the union's resources could be mobilized. If a strike were required to obtain a contract, all of the union's strike funds were available to be mobilized against the "target company." After a contract was signed, the union would use it to set a "pattern" for the industry. Each of the other auto producers was then approached for a similar contract.

Frank Lorenzo, on the other hand, presents a management permutation of this model - the obverse side of the same strategy. He has taken over airlines and forced their workforces to make major concessions in wages and working conditions. With these new agreements in hand he uses his newly acquired cost advantages to take over still more airlines. The workers for these companies are then given an ultimatum to lower their wages and working conditions. Not surprisingly, Lorenzo uses the workers he forced to grant concessions in his other airlines as standards for comparison. This practice is called "whip - sawing", since one set of concessions is used against another company's employees to get further cuts. In a sense Lorenzo is an "equal opportunity wage cutter." The sacrifices he demands from one, he demands from all. He is operating his labor policy as if all of the employees working for his various airlines are really working for a single company.

The introduction of the fare war during Eastern's strong season is just another chapter in his design to monopolize the market. He is evidently willing to run the risk of lowering Eastern's profits by cutting its revenues during its strongest market period because his current campaign against the employees depends on a continued financial crisis at Eastern. Lorenzo's plan to force further concessions from the Eastern employees is, therefore, assured by his farming - out of maintenance work and fare cutting. If the balance sheet improved before he got concessions and the corollary objective of weaker unions, his momentum would be lost. This kind of financial manipulation relies on media and public support for success. If he " made that phone call to himself" too early and Eastern recovered financially, he would not be able to continue to demand concessions and maintain the appearance of being a corporate savior in the Public's mind.

Three questions remain unanswered:

1. "Who's next?" If Eastern falls according to plan, Lorenzo must continue toward his goal of monopoly control. The final chapter, when and if he attains such a position, will involve his control of fares in order to maximize his overall profits. At that time, he will have minimized costs through actions such as wage and benefit concessions, and he will cancel all fare wars in order to maximize profits.

2. "Why should Texas Air, with its largest airline, Continental, in bankruptcy be allowed to continue to buy controlling interest in more airlines?" Since bankruptcy at Continental enabled Texas Air to avoid legal debts to banks and suppliers and to negate the conditions of contracts with employees, this takes on the appearance of a rhetorical question. Common sense , if not the law, should require Texas Air to salvage its bankrupt subsidiary before expanding its airline empire. Empires were not meant to be purchased by funds generated by obligations escaped under bankruptcy law. While the laws have been changed to prevent Frank Lorenzo from

using bankruptcy at Eastern in the same way, he is still reaping the financial benefits of his bankruptcy at Continental. Eastern employees are still being "whip-sawed" by comparisons with the reduced rates of remuneration at Continental. The dramatic wage concessions at Continental were the direct result of that bankruptcy tactic. Clearly, he is still using the law to his financial benefit.

3. "Who will be able to afford to fly?" The fallacy in Lorenzo's plans is the implicit assumption that only his airlines will institute a policy of setting a single, Entry Wage, for their workforce. As discussed, the compression of wage spreads within each job classification is not limited to Texas Air holdings and is being introduced in the public sector. As unemployment rises and the institution of a single, Entry Wage permeates the economy, more and more employers will follow the Lorenzo lead. The answer to this question is that the average worker may not be able to afford to fly.

The fallacy of composition is that the whole does not equal the sum of the parts. While one employer may be able to cut wages and benefits and pass the full burden of the resulting multiple reduction in the area's income onto other corporate and personal balance sheets, the setting of the example can come back to haunt him. If all employers, for example, try to set wages at the Entry Level for all classifications, they will be defeated in their goal to increase their profits. While their costs may fall, their revenues - because of the reduced purchasing power of their workers/consumers - will fall even more. It should be recalled the Bureau of Labor Statistics data would indicate a 40 percent drop in Miami's incomes if the entry wage were institutionalized in the area.

In short, Frank Lorenzo's profit maximization is self-defeating. The seeds for its undermining are sown by the visibility of its initial successes. Emulation by others will lead to not only the deterioration of the "humaneness" of the working conditions and incomes achieved since the Industrial Revolution, but also to lowering of the standard of living and welfare for society as a whole.

POSTCRIPT

After the completion of this Report, one important development has occurred which reinforces its conclusions. Eastern Airlines announced on February 11, 1987 a fourth quarter profit for 1986 of $6 million (Miami Herald, February 12, 1987, pp.1(26)). In the fourth quarter of the prior year, Eastern experienced a loss of $67.4 million.

Eastern's financial picture has changed dramatically without the cuts in wages and benefits currently demanded by Texas air. This Report concludes that Lorenzo cannot affort to have Eastern become profitable before he accomplishes his goal of "whip-sawing" the employee unions into a 28.8 percent cut in wages and benefits. To do this would endanger his public image of being a corporate savior. In light of the fourth quarter profit, the fare cuts at Eastern of up to 40 percent during its peak season are consistent with this conclusion. Texas Air cut Eastern's fares on January 30, 1987--just one month after the dramatic return to profitability, but before the public announcement of such. Fare cuts of the proposed magnitude will erode a $6 million profit quite easily. In fact, Texas Air will be able to control the amount of the loss incurred by changing the number of seats per flight which qualify for the reduced rates.

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GAMES CORPORATIONS PLAY: A THEORY OF TENDER OFFERS

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In the debate over tender offer regulation, the line has been drawn between those who believe tender offers create value (by replacing inefficient management) and those who believe they simply redistribute value between the shareholders of two corporations. Professor Leebron argues that this dichotomy misses the point, because tender offers both create value and distribute the value created. His richly textured analysis focuses on the acquirer's decision to combine the two corporations and on its choice of tender offer as the acquisition mechanism. Drawing from literature on bargaining, game theory, and auctions, Professor Leebron shows that tender offers and negotiated mergers distribute gains differently and that this difference may influence the size and type of gains created. Professor Leebron concludes that our lack of knowledge about the incentives necessary for the creation of acquisition gains should make us uneasy about far-reaching tender offer regulation. He argues that tender offers should instead be regulated like mergers or other corporate structural changes, through enabling statutes that set default or minimal standards allowing for variation in the corporate charter.

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INTRODUCTION

The nearly obligatory observation commencing any writing on the subject of tender offers is that no machination of the corporate or financial world has ever attracted greater attention from lawyers, legal scholars, financial economists, or the lay press. The sheer magnitude of the sums involved[1] might explain why tender offers and their supporting actors have become front-page material, but the more likely source of fascination is the identification of the tender offer as a kind of financial warfare.[2] Nothing attracts attention quite like war or money, so the combination is understandably irresistible.

Both the SEC and Congress have recently refocused their attention on the problems associated with tender offers. The SEC has launched a comprehensive examination[3] of tender offer regulation, and Congress is

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[1] In 1985, 121 tender offers were made for a total value of $46.8 billion, including 17 tender offers worth a billion dollars or more. Austin & Mandula, Tender Offer Update: 1986, Mergers & Acquisitions, July-Aug. 1986, at 55, 55. Between 1978 and 1985, 923 tender offers were made for a total value of $241 billion. Id.

[2] See, e.g., 1 M. Lipton & E. Steinberger, Takeovers and Freezeouts vii-viii (1978); Gilson, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept, 34 Stan. L. Rev. 775, 775-76 (1982).

[3] In February 1983, the SEC established an Advisory Committee on Tender Offers. See Exchange Act Release No. 19,528, 48 Fed. Reg. 9111 (1983). The Committee issued its report less than five months later. See Advisory Comm. on Tender Offers, U.S. Sec. & Exch. Comm'n, Report of Recommendations (July 8, 1983) [hereinafter SEC Advisory Committee Report]. Since the issuance of the Advisory Committee Report, the SEC has made a number of rulemaking and legislative proposals, only some of which are related to the Report. See, e.g., Exchange Act Release No. 20,581, 49 Fed. Reg. 3064 (1984) (adopting Rule 17Ad-14 concerning the processing of tender offers within the National Clearance and Settlement Sys-

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considering the most far-reaching tender offer legislation[4] since it passed the Williams Act in 1968.[5] But despite the fact that every available microscope has been focused on this phenomenon, there remains little agreement on what is right with it, what is wrong with it, and even how to approach it.

Every school of thought is well represented in the literature, from the Chicago apostles of the free market in corporate control[6] to those who would virtually prohibit the offers without management[7] or regulatory[8] approval. To the Chicagoans, the analysis is simple: tender offers

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tem); Exchange Act Release No. 21,079, 49 Fed. Reg. 26,751 (1984) (proposing regulations concerning two-tiered pricing in tender offers and nontender offer purchase programs); Exchange Act Release No. 21,782, 50 Fed. Reg. 8100 (1985) (adopting an amendment to Rule 10b-4 prohibiting hedged tendering via call options); Exchange Act Release No. 23,431, 51 Fed. Reg. 28,873 (1986) (adopting all holders rule).

[4] Current congressional proposals include placing restrictions on two tiered bids, stock repurchases (greenmail), golden parachutes, and other defensive tactics by target management; expanding the minimum offering period; and creating a federal cause of action to challenge management actions during tender offer periods. See Takeover Tactics and Public Policy: Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the Comm. on Energy and Commerce, 98th Cong., 2d Sess. (1984); Tender Offer Practices and Corporate Director Responsibilities: Hearing on S. 2448 & S. 2797 Before the Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. (1984) [hereinafter Tender Offer Practices]. Recent scandels involving insider trading are producing a new flood of legislative proposals.

[5] Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982)).

[6] See, e.g., Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982) [hereinafter Easterbrook & Fischel, Auctions]; Easterbrook & Jarrell, Do Targets Gain From Defeating Tender Offers?, 59 N.Y.U. L. Rev. 277 (1984); Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698 (1982) [hereinafter Easterbrook & Fischel, Corporate Control]; Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981) [hereinafter Easterbrook & Fischel, Proper Role]; Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 Bus. Law. 1733 (1981) [hereinafter Easterbrook & Fischel, Takeover Bids]. Professor Gilson's writings are also in this vein. See Gilson, supra note 2; Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819 (1981). The President's Council of Economic Advisers also appears to have accepted the view that takeovers serve efficiency goals. See Economic Report of the President, The Annual Report of The Council of Economic Advisors 187-216 (1985) [hereinafter CEA Annual Report]. The CEA found "overwhelming" evidence that the economy benefits from mergers and acquisitions. Id. at 197. The CEA suggested, furthermore, that tender offer regulations may cause real economic losses; it asserted that the Williams Act, by forcing potential bidders to pay higher premiums to target shareholders, has deterred beneficial transactions from taking place. Id. at 203-04.

[7] See, e.g., Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101, 113-20 (1979) [hereinafter Lipton, Takeover Bids]; Lipton, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel, 55 N.Y.U. L. Rev. 1231 (1980); Lipton, Takeover Bids in the Target's Boardroom: An Update After One Year, 36 Bus. Law. 1017 (1981). Cf. Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 Colum. L. Rev. 249, 317 (1983) (proposing that all tender offers not approved by management remain open for at least six months).

[8] See, e.g., SEC Advisory Committee Report, supra note 3, at 122 (statement of Arthur J.

are the means of acquiring corporate control when an inept or disloyal management is hostile to a value-creating acquisition.[9] Others argue that tender offers are used when the stock market for one reason or another undervalues a corporation's shares, allowing the bidder to realize a gain through a bargain purchase.[10] Thus, some see the tender offer as good because it polices incompetent management, and some see the tender offer as bad because it allows corporate raiders to steal value from existing stockholders. In other words, as pointed out by Professor Coffee,[11] the line has been drawn between those who believe tender offers create value (by replacing inefficient management) and those who believe they simply redistribute value between the shareholders of two corporations.[12]

This dichotomy, however, ignores what I believe to be the most important aspect of corporate acquisitions, namely, they both create value and distribute the value created. That legal rules will help determine the distribution of the value created by acquisitions is commonly recognized. Too often overlooked, however, is the equally important point that the distribution scheme we choose may in turn influence whether and how much acquisition value is created in the first place.[13] The tender offer, in

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Goldberg); Goldberg, Regulation of Hostile Tender Offers: A Dissenting View and Recommended Reforms, 43 Md. L. Rev. 225 (1984). Justice Goldberg would require an independent determination by a person or institution selected by the SEC of (1) whether the offer is fair to shareholders of both the acquirer and the target and (2) "whether, in economic terms, the public interest is protected." Goldberg, supra, at 229. This review, however, would only be for the purpose of "informing shareholders," and a determination that the offer is unfair would not constitute a regulatory prohibition. Id. at 229 n.17. It is unclear what purpose is served by a determination that the offer is not in the public interest if shareholders, whose interests do not necessarily coincide with the public's, are still free to accept the offer. For a recent legislative proposal requiring that major acquisitions meet a "public interest" test, see H.R. 3561, 98th Cong., 1st Sess. (1983).

[9] See, e.g., Easterbrook & Fischel, Proper Role, supra note 6, at 1169-74; Easterbrook & Fischel, Takeover Bids, supra note 6, at 1735-36.

[10] See, e.g., Lipton, Takeover Bids, supra note 7, at 108; Lowenstein, supra note 7, at 306. This argument has been referred to as the "information hypothesis": tender offers are initiated by the bidding firm's "discovery" that the target's resources are "undervalued or underutilized." Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers: Information or Synergy?, 11 J. Fin. Econ. 183, 204 (1983).

[11] Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 Colum. L. Rev. 1145, 1152-54 (1984).

[12] An additional and widely voiced objection to tender offers is that they dissipate resources and credit that would otherwise be available for investment in new productive assets. See The Credit Control Act of 1983: Hearing on H.R. 1742 Before the Subcomm. on Economic Stabilization of the Comm. on Banking, Finance, and Urban Affairs, 98th Cong., 1st Sess. (1983); To Extend the Credit Control Act: Hearings on H.R. 6124 Before the Subcomm. on Consumer Affairs and Coinage of the Comm. on Banking, Finance, and Urban Affairs, 97th Cong., 2d Sess. (1982); cf. Brobeck, The Merger Boom and High Interest Rates, reprinted in Future of Financial Markets: Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the Comm. on Energy and Commerce, 98th Cong., 1st Sess. 209-26 (1983). But see CEA Annual Report, supra note 6, at 201.

[13] Professors Easterbrook and Fischel, of course, do see tender offers as value-creating

other words, may have important efficiency consequences well beyond the job security of corporate managers and the bank accounts of raiders and target shareholders.

The tender offer is not the only means to an acquisition. Rather, it stands as an alternative to the negotiation of a merger (or sale of business) with the management of the corporation sought to be acquired. Because the primary difference between these two acquisition methods is the role of target management, whose approval is required for a negotiated merger but not for a tender offer, the bulk of the literature on tender offers has focused on the proper conduct of target management in responding to a tender offer.[14] Again, the views range from one extreme (management should do absolutely nothing to oppose the offer)[15] to the other (management is entitled to do almost anything in its power to block the offer if it believes the offer is not in the shareholders' best interests).[16] But emphasis on the role of the target seems somewhat misplaced, in that it is often the acquirer that decides in the first instance on the acquisition procedure.

Relying on empirical and theoretical evidence, this Article develops a partial theory of tender offers that reflects more fully the fact that tender offers are but one form of acquisition procedure and that the choice of the procedure is largely within the hands of the acquiring corporation. The question why the acquirer decides to make an acquisition by tender offer can be separated into two questions: first, why the acquirer seeks a combination of the two firms at all, and second, why the acquirer seeks to achieve the combination through the tender offer technique rather than some alternative, such as a negotiated merger. It may turn out that the answer to the first question, namely, the reason for the combination in the first place, explains the method of acquisition. This suggestion is implicit, for example, in the theory that tender offers serve primarily as a means of creating value through the displacement of inefficient management.[17] But as I hope to show, thinking about these two questions separately and carefully leads to new explanations for tender offers and highlights serious problems with some widely advocated regulatory approaches.

Part I of this Article demonstrates that, although tender offers and negotiated mergers serve essentially identical purposes, an acquirer may be able to pay less in a tender offer because of certain limitations on the stock market's ability to fully value the acquired firm. Drawing on a provocative body of nonlegal literature concerning bargaining, game theory, and auctions, Part II suggests that tender offers (whether of the "Saturday Night Special"[18] variety or seemingly competitive "auctions"[19]) result in a different distribution of gains from corporate combinations than do negotiated mergers. Part III shows that this distributional effect may influence the size and type of gains that will be created, and in particular, may discourage potential acquired firms from investing in programs that would produce synergy gains[20] in a corporate combination. Finally, Part IV briefly suggests some implications of the

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transactions and are keenly aware that a distribution rule allotting some of these gains to target shareholders may discourage tender offer activity. Because of their obsession with the idea of purging inefficient management, however, Easterbrook and Fischel are really concerned about the impact of distribution rules on the *identification* of this one type of gain from acquisitions and the consequent discouragement of the managerial inefficiency which leads to the possibility of gain rather than on the *creation* of the various types of acquisition gains, such as those deriving from synergies. See pp. 205-15 infra.

[14] In addition to the sources cited in notes 6-7 supra, see, e.g., Friedenberg, Jaws III: The Impropriety of Shark-Repellent Amendments as a Takeover Defense, 7 Del. J. Corp. L. 32 (1982); Gelfond & Sebastian, Reevaluating the Duties of Target Management in a Hostile Tender Offer, 60 B.U.L. Rev. 403 (1980); Harrington, If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids, 34 Syracuse L. Rev. 977 (1983); Lynch & Steinberg, The Legitimacy of Defensive Tactics in Tender Offers, 64 Cornell L. Rev. 901 (1979); Oesterle, Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis, 71 Cornell L. Rev. 53 (1985). In addition to this more general policy-oriented literature, there is a massive amount of writing on the legality of various defensive tactics under Rule 14(*e*) of the Williams Act, on specific antitakeover tactics and devices (much of which is in the "how to" vein), and on various state antitakeover statutes.

[15] Professors Easterbrook and Fischel propose "managerial passivity" as the rule to ensure maximum efficiency in the market for corporate control. Easterbrook & Fischel, Proper Role, supra note 6, at 1201-04.

[16] See Lipton, Takeover Bids, supra note 7, at 101-31 (arguing that resistance by target management is necessary to defend against inadequate offers).

[17] See, e.g., Easterbrook & Fischel, Proper Role, supra note 6, at 1169. Professors Easterbrook and Fischel are at a loss to explain why acquirers seeking synergistic gains rather than the replacement of inefficient target management would choose to accomplish the acquisition through a tender offer rather than a merger. This Article sets forth both empirical evidence and a theory why acquirers might prefer tender offers regardless of the source of gains.

[18] The term "Saturday Night Special" was coined to describe tender offers prior to the Williams Act that were initiated during a weekend, kept open for only a few days, and pursued without the target company's prior knowledge. See Tender Offer Practices, supra note 4, at 140. The term is part of the "warfare" terminology that has become endemic to tender offers; it applies also to a notoriously cheap and concealable handarm that has been used in a number of assassination attempts and street violence and is often the object of gun control legislation and proposals. J. Wright, P. Rossi & K. Daly, Under The Gun: Weapons, Crime, and Violence in America (1983). See also Kelley v. R.G. Indus., Inc., 304 Md. 124, 497 A.2d 1143 (1985).

[19] An "auction" in the context of tender offers refers to the process by which competing offerors seek to obtain control of a single target corporation. This competition may be manifested in a series of increases in the tender offer price, or in modifications of other terms and conditions of the offer. For a fuller discussion of auctions and the extent to which tender offers resemble a competitive auction market, see text accompanying notes 133-47 infra.

[20] The term "synergy" is generally defined in the literature as occurring "when the value of the companies combined is greater than the sum of the values of each company separately." Note, The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach, 88 Yale L.J. 1238, 1244-45 (1979). The use adopted in this Article is

analysis presented in this Article for tender offer regulation, concluding that the case for a flat ban on all defensive tactics has not been proven, and that regulatory policy should begin to better accommodate the varying needs of individual firms.

I

THE MEANS, MARKETS, AND PRICES FOR CORPORATE ACQUISITIONS

A. Tender Offers Compared to Mergers

Surprisingly little of the mountain of literature on corporate takeovers has focused on the significance of the tender offer as one of several means for achieving the combination of two firms.[21] True, those who have thought in terms of the "structure" of the corporation have stressed the importance of the tender offer as a means of disciplining management that, unlike a proxy fight, is not subject to management's control.[22] Corporate structure, however, has significance not only for the managers and stockholders who are part of that structure, but also for those outside the structure with whom the corporation deals, such as suppliers, customers, and potential acquirers. When a company contemplates an acquisition or discusses a merger with another company, its planning takes place against a legal background of which both the negotiated merger and the tender offer are salient parts.

A company that identifies an attractive acquisition normally approaches that firm's management to discuss a merger. If the target's management refuses to agree to the acquisition by merger at a reasonable price, then the only alternative left open to the acquirer is a tender offer. But is resistance by target management the only reason to launch a tender offer rather than negotiate a merger? And is the inefficiency or disloyalty of management the only explanation of its hostility? If the answer to these questions is yes, or even predominantly yes, it may make sense to allow the bidder to go over the heads of management and appeal directly to the shareholders. Indeed, it is hard to imagine that the shareholders would want it any other way. But until we more fully understand the relationship between the run-of-the-mill negotiated merger and

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somewhat narrower, excluding purely private gains (such as tax savings) and also the mere replacement of management.

[21] A noteworthy exception is Bebchuk, The Case For Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028 (1982). In taking account of the effect of tender offers on merger negotiations, Professor Bebchuk endorses a rule of auctioneering. My analysis of the effect of auctions differs substantially from Professor Bebchuk's. See text accompanying notes 143-47 infra.

[22] Gilson, supra note 2, at 818-22; Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965).

the tender offer, any proposal for regulatory reform risks unintended economic consequences.

To understand the relationship between the negotiated merger and the tender offer, we first need to know why firms engage in acquisitions. The two received theories for acquisition activity may be referred to as the "shareholder welfare" and "managerial maximization" theories.[23] The shareholder welfare theory holds that firms engage in acquisitions in order to increase the welfare of their own shareholders by increasing the value of the firm's shares.[24] If an above-market premium is paid for the acquired firm, this theory implies either that the market did not accurately value the target's shares (the bargain purchase theory)[25] or that the acquisition itself (or more accurately the combination of the two firms) creates value, or both.[26]

The managerial maximization theory, on the other hand, holds that managers decide to acquire other firms because an acquisition increases their own welfare, even though it may diminish the welfare of their stockholders.[27] Several studies have shown that managerial perquisites, including power, job satisfaction, and salary, are more closely linked to firm size than to profitability.[28] Since an acquisition is the quickest (and probably the least risky) means of expanding firm size, managers will make acquisitions in order to increase their own welfare. Under the managerial maximization theory, the payment of a premium need not reflect any prior undervaluing of the target firm or any value created by the merger. Rather, it may reflect merely a transfer of wealth from the bidder's shareholders to the target's—that transfer being an agency cost[29] of the separation of ownership and management.

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[23] See, e.g., Firth, Takeovers, Shareholder Returns, and the Theory of the Firm, Q.J. Econ., Mar. 1980, at 235, 235-36; Halpern, Corporate Acquisitions: A Theory of Special Cases? A Review of Event Studies Applied to Acquisitions, 38 J. Fin. 297, 299 (1983).

[24] See Halpern, supra note 23, at 314 (concluding that the empirical evidence from both merger and tender offer studies generally supports the shareholder welfare theory).

[25] With respect to companies whose shares are traded on a national securities exchange, the bargain purchase theory is inconsistent with the efficient capital markets hypothesis, which holds that the prices prevailing on such stock markets are the best indication of their value. See Easterbrook & Fischel, Takeover Bids, supra note 6, at 1734-35; note 42 and accompanying text infra; see also SEC Advisory Committee Report, supra note 3, at 43-49 (statement of Frank H. Easterbrook and Gregg A. Jarrell) (including a vituperative attack on Professor Lowenstein and his article, supra note 7, favoring the bargain purchase theory).

[26] See Halpern, supra note 23, at 299-300, 313-14.

[27] See E. Herman, Corporate Control, Corporate Power 96-97 (1981); S. Reid, Mergers, Managers, and the Economy 131-52 (1968); Firth, supra note 23; Note, supra note 20, at 1243-44. Those who subscribe to this view have been particularly critical of conglomerate mergers. See, e.g., S. Rhoades, Power, Empire Building, and Mergers (1983). There is some empirical evidence that conglomerate mergers do not enhance the welfare of the acquirer's shareholders, and that shareholders achieve greater returns by diversifying on their own. Mason & Goudzwaard, Performance of Conglomerate Firms: A Portfolio Approach, 31 J. Fin. 39 (1976).

[28] See, e.g., W. McEachern, Managerial Control and Performance 7-15 (1975); S. Reid, supra note 27, at 133-39; D. Roberts, Executive Compensation 50-108 (1959); Note, supra note 20, at 1243-44.

In some circumstances, of course, it may be possible for management to increase its own welfare through acquisitions without diminishing (or increasing) shareholder welfare. For example, management may choose an acquisition program instead of a stock repurchase program when the two result in equal value to shareholders.[30] To the extent that investment rather than dividend payment is desirable, there is no nontax reason for a firm to prefer direct investment in real assets as opposed to the acquisition of financial assets representing control of a going concern. Thus, in a financial environment which for whatever reason favors expansion, one would expect acquisition activity to be one form of expansion.

Both the shareholder welfare and managerial maximization theories reflect an assumption of self-serving behavior: managers serve either themselves, their shareholders, or some combination. Bidders are not in this billion-dollar game to act as police officers on behalf of the stockholders of potential target companies. Of course, if the target company is poorly managed, the bidder may be able to realize a profit if it can obtain control and ownership at prevailing prices and more efficiently manage the assets. But even if the target company is well managed, any possibility of realizing a profit because the target is worth more in its hands will provide the bidder with incentive for the combination.

Although tender offers and mergers share similar motivations, are they directed at achieving precisely the same acquisition goal? From the

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[29] Agency costs are costs deriving from the divergence of interests of the corporate managers (the agents) and the stockholder owners (the principals). See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308-09 (1976). Such costs are inherent in the seperation of ownership and control, but they may be minimized by adopting various monitoring devices, such as "budget restrictions, compensation policies, [and] operating rules." Id. at 306 & n.9.

[30] If the firm's cost of capital is equal to the return it can earn on new investments, then it should be indifferent between repurchasing (some say investing in) its own shares and making a new investment from available funds. Gains to shareholders from either reinvestment or stock repurchase will be taxed at favorable capital gains rates unless the repurchase is construed as a dividend. If for some reason a stock repurchase program is not feasible or advantageous to stockholders (because, for example, it would result in an undesirable concentration of ownership, require the payment of a premium that would depress the value of remaining shares, or be construed as a dividend), management could pay substantial premiums for acquisitions without diminishing shareholder welfare. Shareholders might be better off receiving a lower return on lower-taxed reinvestment income than a higher return on a smaller amount of aftertax dividends. Thus, if profitable investment opportunities are not readily available, a firm may be willing to accept a lesser return on an investment in order to avoid paying a dividend. And even a slightly lesser required rate of return on its investment may enable the bidder to pay an enormous premium.

point of view of the bidder, a tender offer theoretically may be used to achieve one of the following goals: (1) acquiring the entire equity interest of a concern; (2) acquiring control[31] over a firm, coupled with the benefits of substantial equity ownership; or (3) acquiring a substantial minority interest in a firm.[32] Only the first of these goals achieves the same result as a merger (and in fact requires a merger as the second step of the transaction).[33] In practice, however, mergers and tender offers are generally used to accomplish the same goal. The third of the above strategies, the acquisition of a substantial minority interest without control, is rarely the subject of a tender offer; open market purchases or negotiated transactions with the target company or stockholders typically can achieve this goal at substantially less cost.[34] And although some bidders choose to acquire only control of a target, the primary use of a tender offer today is as a step in the achievement of the first goal, the acquisition of the entire equity interest.[35]

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[31] Legal control of a company requires ownership of over 50% of the voting stock, although certain actions such as dissolution may, under state law or corporate charter provisions, require a higher vote. Minority or "working" control of a company exists when a stockholder or a group of stockholders is able to dominate the corporation without holding a majority of shares. In a widely held public corporation, the amount necessary to exercise such control may be less than 15%. A. Berle & G. Means, The Modern Corporation and Private Property 69, 78 (rev. ed. 1968).

[32] There are at least two other possible goals, namely triggering another tender offer at a higher price and triggering a tender offer for the initial bidder, but these goals depend on another company pursuing one of the above goals.

[33] Even an attractive, management-endorsed tender offer for "any and all" shares of a public corporation will never result in all outstanding shares being tendered. Some shareholders may not be aware of the tender offer or even aware that they are shareholders. Since retaining even a small minority of shareholders may result in large costs (either because of registration or reporting requirements or because of the need of the majority to avoid certain kinds of self-dealing), the acquirer will eliminate the minority through a second-step merger.

[34] One reason open market purchases cost less is the virtual absence of transaction costs, except for the relatively small fee of an investment banker or broker. A second reason is that some amount of open market purchases can be accomplished without public disclosure. Under the Williams Act, a company must file a statement within 10 days of acquiring 5% of the equity of another corporation. 15 U.S.C. § 78m(d)(1) (1982). This 10-day "window" in effect allows a company to acquire considerably more than 5%, since a common procedure is to buy just under 5% at a leisurely pace, and then acquire as much stock as possible within 10 days of the next purchase. This strategy may allow a company to accumulate 10% to 20%, a substantial minority interest, before filing the required Form 13D. Finally, open market purchases are less costly if one believes that the supply curve for a firm's shares is upwardly sloping. See note 100 infra. Since in a tender offer the offeror must pay the same price to all shareholders, the total amount paid will be the number of shares sought multiplied by the price it takes to buy the last share sought. Open market purchases, on the other hand, may be effected sequentially at the lowest price of any available shares.

[35] From 1981 to 1983, 83% of tender offerors acquired the entire equity interest of the target, whether through an any-or-all offer or a two-tiered bid. Exchange Act Release No. 21,079, 49 Fed. Reg. 26,751, 26,760 (1984) (table 1). An earlier study concluded that freezeout mergers followed within five years in 72% of the cases. Dodd & Ruback, Tender Offers and Stockholder Returns: An Empirical Analysis, 5 J. Fin. Econ. 351, 352 & n.2 (1977).

Thus, the tender offer is primarily an alternative to a negotiated merger or purchase of assets. Adopting this perspective, we will want to ask whether a firm might in some circumstances prefer to make an acquisition by hostile tender offer rather than negotiated merger. There are two possible explanations why it might choose a tender offer. First, the transaction costs may be less. Although there is little empirical evidence directly on this point,[36] under present tender offer regulation, such savings seem highly unlikely,[37] and in any event a negotiated acquisition could always be effected through a friendly tender offer.[38]

Second, and more plausibly, the effective price of the acquisition may be less.[39] This factor would explain not only a firm's initial preference for a tender offer but also a firm's resort to a tender offer when disagreements as to price stymie merger negotiations.[40] If the price of an acquisition made by tender offer is less, the question is why. Answering this question requires that we understand the nature of pricing in the market in which tender offers take place, namely, the stock market.

B. Valuation in the Markets for Corporate Control

The smallest price a tender offeror will have to pay is the aggregate market value of all the outstanding shares, since no shareholder would sell for less than the prevailing market price.[41] Let us start with the as-

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[36] One somewhat outdated study (covering the years 1956-1970) estimated transaction costs of tender offers at between 14% and 22% of the market price of the shares acquired. Smiley, Tender Offers, Transaction Costs and the Theory of the Firm, 58 Rev. Econ. & Statistics 22, 29-30 (1976). For a description of the types of transaction costs associated with tender offers, see Gilson, supra note 6, at 841 n.86.

[37] See, e.g., Easterbrook & Fischel, Proper Role, supra note 6, at 1169 (stating that "a tender offer is by far the more costly device").

[38] Moreover, in the case of hostile tender offers, there are the added costs of dealing with hostile management of the target and possibly integrating it into the combined firm.

[39] Such a price should be measured not only by the consideration paid to each shareholder, but also by the transaction costs and any side payments. For example, a merger may require a side payment to the corporate managers of the target corporation. Finally, the price should be risk adjusted. Thus, if acquisitions by tender offer are more risky than acquisitions by negotiated merger, see note 81 and accompanying text infra, an acquirer would be willing to pay less in a tender offer than in a merger.

[40] For a discussion of the reasons why advantageous bargains may not be reached, see Cooter, The Cost of Coase, 11 J. Legal Stud. 1, 14-27 (1982). In some cases, an attempted merger negotiation may fail because information discovered in the course of the negotiation makes the acquisition no longer desirable.

[41] Since all shareholders have the opportunity to sell their shares in the market at the currently prevailing price, the majority of shareholders who at any point in time are not selling their shares presumably prefer to retain their shares over selling them at that price. There would be no reason for this judgment to change in the face of a noncoercive tender offer.

But for the existence of state appraisal statutes, it would be possible to construct an offer for a price lower than the aggregate market value of all outstanding shares. Suppose, for example, that the shares of the target are trading at $100. An offeror makes an offer for 50% of the shares at $105, to be followed by a freezeout merger at $93, resulting in an average per

sumption that the securities market is efficient in the sense that the market price is the best (most accurate) available assessment of the value of the target firm in the hands of the present management and shareholders.[42] That value, which I call *V*, will be primarily a function of the discounted value of future dividends[43] (which in turn will relate primarily to expected future earnings).

An acquirer may be willing to pay more than *V*. The willingness to pay a premium may result either from real gains which are expected to derive from the acquisition, from tax savings which produce greater aftertax cash flows without any real efficiencies, or from management's willingness to increase its own welfare at shareholder expense. For now, however, I will assume that the transaction is being undertaken because the acquirer's management believes the transaction will produce real gains for its shareholders. Such gains would be realized in the form of greater earnings, or less risk, from the combined assets of the target and the acquirer.[44] The value of the firm in the hands of the bidder (the

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share price of $99. This offering structure results in a prisoner's dilemma, see note 118 and accompanying text infra, with the payoff structure dependent on the number of other shareholders who tender. If a shareholder tenders, he will receive an average per share payment of $99 if the offer is successful and $100 if it is not. If he fails to tender, he will receive $93 if the offer is successful and $100 if it is not. Thus, tendering is the less risky strategy and maximizes the minimum amount the shareholder will receive (the so-called mini-max strategy). While neither federal law nor the most widely applicable state corporation code (Delaware's) would prevent this coercive strategy, the effect of appraisal statutes would likely be to force the acquirer to pay $100 in the freezeout merger. See Weinberger v. UOP, Inc., 457 A.2d 701, 712-15 (Del. 1983); see also N.Y. Bus. Corp. Law § 623 (McKinney 1986).

[42] This assumption goes somewhat beyond the traditional definitions of market efficiency, but not beyond that accepted by many writers on tender offers, including Easterbrook & Fischel, Takeover Bids, supra note 6, at 1735, and Gilson, supra note 6, at 823-24. The widely accepted definition of market efficiency derives from Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383 (1970), which succinctly defines an efficient market as "[a] market in which prices always 'fully reflect' available information." Id. at 383. Thus, the concept of market efficiency posits a relationship between information and prices, and in particular between information bearing on future returns and prices. The claim of market efficiency can be reduced to the claim that no investor can earn superior returns by trading on information. This limitation is important in that it relates only to what might be called "financial" or "speculative" efficiency: present market prices are the best indicators of future market prices. This does not necessarily imply that present market prices are also the best indicators of "allocative" efficiency, or the real returns from the firm's real assets. For an excellent discussion of this distinction between "speculative" and "allocative" efficiency and its possible implications, see Gordon & Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761 (1985).

[43] See R. Brealey, An Introduction to Risk and Return from Common Stocks 68 (2d ed. 1983). But see Shiller, Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?, 71 Am. Econ. Rev. 421 (1981).

[44] On the relationship between risk and return, see generally R. Brealey & S. Myers, Principles of Corporate Finance 117-63 (2d ed. 1984). It is unlikely, however, that the acquiring corporation could pay a premium solely for risk reduction relating to pure diversification, since shareholders could so diversify on their own. See Note, supra note 20, at 1244. Other forms of

maximum price it could pay without diminishing the welfare of its own shareholders) is called *A*, for acquisition value.

An initial question is under what circumstances the divergence between the values *V* and *A* will be significant. To answer this question, we must make a more exacting inquiry into the nature of share valuation. In the hands of the nonmanagerial shareholder, the share is a fungible commodity.[45] There is substantial evidence that the market for such shares, as financial instruments, is efficient and that the prevailing price is an equilibrium price.[46] The important attributes of such widely traded securities, namely, their risk and return, can be easily duplicated in the marketplace.[47] But this does not at all mean that the corporation, and hence corporate control, also are commodities in that sense. Rather, as a unique collection of assets, goodwill, and employees, the market for corporations is more like the market for individuals with unique talents.[48] The value of such an individual will depend on the specific needs of potential "acquirers," that is, employers. Similarly, the unique combination of corporate attributes is unlikely to be easily duplicated, and neither buyers nor sellers in the market for corporate control are passive "price takers."[49]

In other words, there are at least two markets in which a corporation may be purchased or sold: the market for corporations and the market for shares.[50] The forces of supply and demand, as well as the

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risk reduction that could not be obtained by shareholder diversification, such as acquisitions to secure outlets or supplies, may decrease the required rate of return, resulting in an increase in share price. Another form of risk reduction that shareholders may not be able to duplicate on their own is the reduction of bankruptcy risk. See note 168 and accompanying text infra.

[45] W. McEachern, supra note 28, at 102 (nondominant shareholders make investments based on risk and return and are indifferent as to the corporations in which they hold shares); cf. Easterbrook & Fischel, Takeover Bids, supra note 6, at 1738 ("Corporations, like apples, are commodities.").

[46] Jensen, Some Anomalous Evidence Regarding Market Efficiency, 6 J. Fin. Econ. 95, 95 (1978) ("[T]here is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis."). For recent surveys of the evidence, see Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 554-57 (1984); Gordon & Kornhauser, supra note 42, at 834-46.

[47] See Jensen, Capital Markets: Theory and Evidence, 3 Bell J. Econ. & Mgmt. Sci. 357 (1972).

[48] See, e.g., H. Raiffa, The Art and Science of Negotiation 104-07 (1982) (using the parable of a famous athlete to illustrate bargaining in the mergers and acquisitions context). Professional baseball players are, within limits, able to sell their unique talents to the highest bidding team (employer). To the extent that certain teams enjoy bidding advantages (through draft rights and contract clauses), these advantages may be similar to leg-ups, lock-outs and other bidding advantages enjoyed during an auction market for corporate control.

[49] A price taker is "a party to a transaction in which the price was determined by natural forces of pure competition." D. Moffat, Economics Dictionary 220 (1976).

[50] See Coffee, supra note 11, at 1171; Lowenstein, supra note 7, at 274-75. In this context, risk arbitrageurs who purchase the stock of potential or actual takeover targets can be understood as arbitraging between the market for shares and the market for corporations.

mechanisms which determine price in these two markets, may differ. A helpful analogy is a condominium or cooperative apartment house next to a building owned and completely occupied by *XYZ* Corporation. The value of each cooperative unit (or rather, the shares that entitle one to the use and possession of that unit) will be primarily a function of the current and expected future rental value of similar units. Thus, an identical apartment in the mirror image building across the street will sell for the same price. However, let us assume the *XYZ* Corporation is now looking for more space. The adjacent apartment building will be particularly desirable, since *XYZ* could, with the necessary building permits, directly connect the offices, and thus save the costs associated with having to communicate with a building that is physically separate and perhaps somewhat distant. *XYZ* will therefore be willing to pay a premium above the ordinary rental value for the building.

XYZ may, however, seek to avoid paying any premium by buying units without disclosing its plans to acquire all the units. *XYZ* might be able to get a number of units without any premium, and others for a premium representing only the transaction costs to the occupant who otherwise would not have chosen to move. Sooner or later, however, the remaining owners will probably become aware of *XYZ*'s plans and will hold out for a greater share of the total "special" or synergistic gains—that unique value arising from *XYZ*'s ownership of the adjacent building. As fewer owners remain, the premium insisted upon by each will be greater. The last owners will have tremendous leverage, since *XYZ* will have already expended resources on premiums that it cannot recoup in the apartment market, and the synergistic gains it counted on can be realized only through the acquisition of the remaining apartments.[51]

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[51] This is essentially a "sunk costs" argument. Sunk costs are expenditures which cannot be recouped without further expenditures. The sunk costs problem faced by *XYZ* may be illustrated by plugging the following numerical figures into the example in the text. Assume that there are 100 apartments with an individual market value of $1 million each, but that the building as a whole is worth $125 million to *XYZ* because of the efficiencies discussed in the text. Assume that *XYZ* has been able to purchase 90 of the apartments for an aggregate price of $100 million. If the apartment building cannot be converted to *XYZ*'s use without acquiring all the units, and the transaction fails at this point, *XYZ* will have sustained sunk costs, in addition to transaction costs, of $10 million (assuming it could resell the individual apartments for $1 million each). In order to avoid this loss, *XYZ* should be willing to pay at least $25 million for the remaining 10 apartments, since it still will not be paying in the aggregate more than it values the building. In fact, it should even be willing to pay more than that. Acquisition of the next 10 apartments will represent a gain to *XYZ* of $35 million, since the 90 units it now holds are worth only $90 million and the entire building will be worth $125 million. Of course, if it does pay the $35 million, the transaction as a whole will have been a $10 million loss. For these reasons, *XYZ* will be reluctant to pay any premiums until it has some assurance that it will be able to acquire all the units. With respect to tender offers, this reluctance explains why most bidders make their bids conditional on the success of the offer (i.e., the tendering of more than 50% of the outstanding shares). Combined with the ability of a 50%

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In the end, if the remaining owners are aware of *XYZ*'s plans and are as skillful bargainers as *XYZ*, it is likely that *XYZ* will pay almost all of its special gain to the owners,[52] although the owners will not share equally. In addition, *XYZ* would run the risk of encountering an irrational owner, who would not sell even at a ridiculously high individual premium. In such a case, the value of all previously paid premiums may be permanently lost. Given this risk, *XYZ* would probably prefer an arrangement by which it could bargain with the owners as a unit (assuming all owners are willing to be bound by the collective decision). Since in the absence of such an arrangement the owners may have to forgo any premium at all, they too would want to bargain as a unit (assuming transaction costs are not prohibitive). Under this scenario, there will likely be some apportionment of the special gain between the apartment owners and *XYZ*.[53] In other words, the transaction would take place more in the context of the market for buildings than in the market for apartment units.

In this crude comparison, a corporation's shares are like the apartments. In the market for shares, the value is primarily determined by the present value of expected income in the form of dividends.[54] If a company determines that ownership of the corporation's assets will be more profitable if consolidated entirely in its hands, it must find a way to obtain complete ownership. As with the cooperative apartment building, there are two basic scenarios. Either the acquiring company can get the equity holders of the proposed acquisition to bargain as a unit (as indeed the managers will have authorization to do, subject to the approval of the requisite shareholder majority), or it can try to buy all the shares from individuals.

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shareholder to approve unilaterally a freezeout merger, this condition assures the acquirer of being able to acquire the entire equity interest or none at all.

[52] Continuing with the example in note 51 supra, if the transaction fails after *XYZ* has acquired 90 units for $100 million, the remaining 10 owners will have a zero gain and *XYZ* will have a $10 million loss. If the transaction succeeds at this point, the remaining owners (collectively) will have as a gain the price paid for the 10 apartments minus $10 million (the prior market value of the apartments) and *XYZ* will have as a gain $35 million (the value of the building to *XYZ* after the transaction is completed minus the value of the 90 apartments it now holds) minus the price paid for the remaining 10 apartments. The net gain from the transaction is $25 million. Assuming this gain is divided evenly, see notes 92-109 and accompanying text infra, *XYZ* will have to pay $22.5 million for the remaining 10 units. Together with previously paid sums, this raises the total price paid to $122.5 million, leaving *XYZ* with a relatively small $2.5 million gain before transaction costs. Of course, other aspects of bargaining, such as the different preferences of the parties for monetary gain, may push the transaction in a different direction.

[53] See notes 92-109 and accompanying text infra. In the hypothetical set forth in note 51 supra, if the owners bargain with *XYZ* as a unit and divide the gains equally (and all owners are bound by any agreement reached), *XYZ* will pay a total price of $112.5 million.

[54] See text accompanying note 43 supra.

With respect to this latter alternative, corporate acquisitions are significantly different from our cooperative building. If the acquirer obtains over half the target corporation's shares, the remaining minority can be forcibly eliminated through a freezeout merger.[55] This possibility largely eliminates any holdout problem and theoretically allows an acquirer to purchase the corporation for much less than it would have had to pay by negotiating sequentially with individual shareholders.[56] In addition, the threat of a freezeout can be used to make the tender offer positively coercive: those refusing to surrender their shares may later be forced out in a transaction in which they will receive substantially less than the offering price.[57]

We began with the assumption that the market for shares accurately values the corporation in the hands of current management and shareholders. In light of the foregoing discussion, the assertion that the market accurately values corporate shares is ambiguous: it does not take a clear position on value arising from transactions like the sale of the apartment building to *XYZ*. If the sale of a corporation also has the potential to generate such gains, we must ask whether the market price reflects that potential. The answer will depend not only on the degree of market efficiency, but also on the legal rules and economic realities that determine whether the shareholders of a corporation will be able to share in gains created by its acquisition. Even if the market is efficient in this regard, the market price of the shares of a potential target will not reflect any value arising from its acquisition if the legal rules and market realities allow corporations to be acquired without any premium.

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[55] The requirements for a freezeout merger vary according to state law and corporate charter provisions. In terms of a vote, the requisite percentage is the number required to approve a merger. There may, however, be additional fiduciary or purpose requirements. In 1977, Delaware decided that such transactions required a business purpose. Singer v. Magnavox Co., 380 A.2d 969, 978-80 (Del. 1977). Although *Singer* was followed in some other states, see, e.g., Perl v. IU Int'l Corp., 61 Hawaii 622, 607 P.2d 1036 (1980), Delaware itself overruled the business purpose requirement of the decision in Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del. 1983), which relegated dissenting shareholders in a freezeout merger to their statutory appraisal remedy. See generally Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 87 Yale L.J. 1354 (1978); Burgman & Cox, Reappraising the Role of the Shareholder in the Modern Public Corporation: *Weinberger*'s Procedural Approach to Fairness in Freezeouts, 1984 Wis. L. Rev. 593; Weiss, The Law of Take Out Mergers: A Historical Perspective, 56 N.Y.U. L. Rev. 624 (1981); Note, Approval of Take-out Mergers by Minority Shareholders: From Substantive to Procedural Fairness, 93 Yale L.J. 1113 (1984).

[56] The freezeout merger eliminates the ability of individual shareholders to prevent the transaction, and thus sharply reduces the bargaining power of each shareholder. Since a shareholder will realize no extra benefit by holding onto his shares, his inclination will be to tender at almost any premium. See notes 114-16 and accompanying text infra. Put differently, without the freezeout each shareholder in effect has a monopoly; the existence of a freezeout replaces a series of bilateral monopoly bargaining situations with a veto game requiring the participation of the offeror (the veto player) and only half of the shareholders (the nonveto players). See text accompanying note 131 infra.

[57] This threat creates a prisoner's dilemma. See note 118 and accompanying text infra.

While the massive and sophisticated literature on valuation[58] cannot be fully examined in this Article, a simplified analysis may cast light on the tender offer situation. A common share represents the discounted value of future returns. But those returns may come in various forms, and the probability of each scenario occurring differs. Greatly simplified, three kinds of things may happen to a corporation: it may continue as a going concern and likely pay dividends at some point, it may be sold (as a going concern), or it may be liquidated. Thus, its value per share of common stock may be expressed as follows:

$$V/n = D + S/n + L/n$$

where V/n represents the value per share, D represents the discounted present value of all future dividends per share (discounted both by the probability and by the required rate of return), S is the net sale price in an acquisition discounted by the probability of such an acquisition and a time factor, L is the net value realizable upon liquidation similarly discounted, and n is the number of shares outstanding (on a probabilistically diluted basis).[59] Thus, the statement that the market for shares accurately values a corporation includes within it the assertion that the market is efficient not only with respect to valuing expected dividends and other normal distributions but also with respect to valuing any potential sale or liquidation of the corporation. To ease analysis, let us assume the L factor is approximately zero and the equation for a target firm can be simplified to $V/n = D + S/n$.[60]

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[58] See generally R. Brealey, supra note 43.

[59] Coffee, supra note 11, at 1192, drawing on Easterbrook & Fischel, Proper Role, supra note 6, at 1164, 1178 n.44, adopts a somewhat differing formulation consisting of the sum of (1) the price that would prevail in the market assuming no takeover occurs multiplied by the probability that no offer will be made and (2) the premium that would be paid over that price multiplied by the probability of such an offer. This approach regards the premium as a sort of "add-on" to the basic value. It is somewhat misleading, in that the merger may call for a complete revaluation of the cash flows.

[60] Generally, liquidation value might be thought to represent a floor below which the stock price theoretically should not fall. For the typical profitable going concern, the dividend value will be far above the net realizable asset value upon liquidation. The higher the dividend value, the less likely that the shareholder's ultimate return will be realized through liquidation. Thus, the L factor should decrease as D increases, and increase as D decreases. Since the typical going concern has a market value far above its liquidation value, the equation will usually be approximately correct if the L factor is eliminated. But the equation does not necessarily imply that a stock will never fall below the liquidation value. On the contrary, in cases where the dividend value falls substantially below liquidation value, the stock is also likely to fall below the liquidation value, because the liquidation value reflects a discount for time and probability. An aggravating factor is that liquidation is a "sticky" phenomenon (like wage decreases). Managers are reluctant to undertake a liquidation, even where it appears to be the efficient thing to do. For this reason, many liquidations take place only after a change in

Why would the acquisition value ever differ significantly from the aggregate dividend value? The mere sale of the corporation does not create an acquisition value different from the dividend value. Unless the acquirer can increase the stream of earnings, or decrease the riskiness of the corporation's operations, it should be willing to pay only the present value of all future dividends, since that is all it would be able to pass on to its own shareholders. The acquisition value will be the same as the dividend value, then, unless the transaction itself creates value. In other words, the value of S will be greater than the value of D only if the corporate managers create corporate assets that are more valuable in the hands of others.

Assuming that the corporate managers have created such assets, how much larger than D will S (undiscounted) be? The answer depends to a large degree on the value arising from the specific acquisition. The sale value S can be viewed as a function of the acquisition value A, which was defined above as the value of the corporation in the hands of the acquirer (or alternatively the maximum price an acquirer should be willing to pay). The bidder presumably is willing to pay any amount up to A, and the target corporation (or its shareholders) presumably is willing to accept any amount greater than D. The difference between A and D represents the gain arising from the acquisition. If all the gains from the combination are paid as a premium to the shareholders of the target, then S will be the same as A. If the gains are divided, then S will be less than A and will depend on how the gains are distributed between the acquiring and acquired corporations. If none of the gains are allocated to the acquired corporation, then S will be no greater than D, and the price of the shares of the corporation will in effect reflect only their dividend value.

As will be discussed more fully below,[61] the price S at which an acquisition is in fact effected will depend on the mechanism of the transaction. Even apart from the question what value S has with respect to a particular corporation, can we be sure that the market price will reflect that value? If it does, then there will be not two distinct markets for corporate control, but only one market reflecting value from both control transactions (acquisitions) and noncontrol (investment) transactions. Thus, before examining in greater detail how we expect the gains from acquisitions to be divided, let us consider more closely the extent to which the market price of the shares will reflect value attributable to the acquisition of the corporation as an entity.

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management, whether through an acquisition or a proxy fight. Cf. Ashton & Atkins, A Partial Theory of Takeover Bids, 39 J. Fin. 167 (1984) (suggesting that takeovers are generally used to effect a change in production plans).

[61] See text accompanying notes 92-147 infra.

C. *Efficiency of the Market for Corporations*

An initial question is whether, assuming the market is efficient with respect to the dividend value of shares, it is also efficient with respect to acquisition value. The efficiency of the market, that is, its incorporation of information available to investors, may vary with different types of information and different distributions of information.[62] The empirical evidence thus far amassed in support of the efficient capital market hypothesis has been based on information specifically related only to the dividend or earnings value of corporate shares. Most fundamental analysis[63] is focused on these attributes, and most shareholders hold shares with the expectation of realizing only dividend value (although much "dividend value" may be realized in the form of capital gains). Thus, in the absence of any indication that there is some specific likelihood of a tender offer, portfolio managers may find it less worthwhile to identify likely acquisition targets than to invest in information relating to future earnings and dividends. The less investment that is made in information, the less likely the market will be efficient with respect to that information.[64] Thus, if many investors and portfolio managers assume a hundred percent probability that shareholder value will be realized through dividend payments, the market will not reflect, or will reflect less well, the potential sale value.

Further limiting the efficiency of the market in this respect is that in many cases it requires knowledge of two firms and of the way they would fit together. Even assuming, as is likely, that analysts could make the appropriate determination if presented with two firms, it may not be worth their while to do so for the universe of possible combinations. This possibility is enhanced by the fact that analysts tend to be specialized by industry. Furthermore, the occurrence of an acquisition, like the liquidation of a company, is a "sticky" phenomenon, and research by those not in a position to bring about the phenomenon may not be adequately rewarded. This is not to say that no acquisition-oriented research is profitable or will be undertaken, but rather to observe that some kinds of acquisition research may not be profitable. Thus, for example, while it may pay investors to attempt to identify companies that would be attractive acquisitions to a large spectrum of companies (for example, companies that are badly managed or should be liquidated), it may not pay investors to research acquisition opportunities that would present gains to only a small universe of possible acquirers. True "synergistic" gains are likely to fall into this latter category. This lack of research might lead to market inefficiency with respect to this type of information.[65]

An additional limit on the efficiency of the stock market with respect to acquisition possibilities is that the information indicating the attractiveness of an acquisition is often not acted upon by those possessing it. For example, such research is primarily carried on by potential bidders and their financial advisers, investment banking firms. Since these firms often do not make large "toe-hold"[66] acquisitions prior to disclosing their intent to make a tender offer, their information will have no effect on the market price unless it is leaked. Thus, the activities of so-called greenmailers[67] such as Carl Icahn may serve to make the market more efficient. They are perhaps the only tender offer participants possessing significant capital who regularly develop information about acquisition opportunities and act on it prior to a tender offer.[68]

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[62] See Gilson & Kraakman, supra note 46, at 554-92.

[63] Fundamental analysis focuses on the fundamental financial aspects of the corporation, namely earnings, dividends, cash flows, assets, and liabilities. It is to be distinguished from technical analysis, which focuses on stock price movements and changes in stock holdings and volume of trades. See generally R. Brealey, supra note 43, at 3-52.

[64] If the market were completely efficient with respect to some type of information, investors would not earn any return by investing in that information. Then, of course, the market would cease to be efficient with respect to that type of information. On this efficiency paradox, see Gordon & Kornhauser, supra note 42, at 786-89.

[65] This analysis may explain some of the drastic price movements that often coincide with rumors of tender offers. The reasons for such jumps may be not merely that the probability of the transaction has substantially increased, but also that the market is for the first time reflecting the value which would arise from such a transaction. This also helps explain why after an unsuccessful tender offer or other acquisition attempt (e.g., a proxy fight) the target's market value may eventually fall back to a price reflecting its fundamental earning potential.

Empirical research on these points is inconclusive. One study found that the stock prices of target firms in unsuccessful tender offers, after rising sharply (18.96%) in the month in which the tender offer announcement is made, retreat only slightly (3.25%) in the following year. Dodd & Ruback, supra note 35, at 370. The authors interpret their findings as consistent with the information hypothesis, see note 10 supra, which posits that target gains can occur without an actual combination, and as inconsistent with the "synergy hypothesis," which asserts that gains from tender offers arise from the combination of the two firms' real assets. Dodd & Ruback, supra note 35, at 354, 370. This study's findings are disputed, however, by more recent analysis which distinguishes between target firms that were subsequently taken over following an unsuccessful bid and target firms that remained independent following an unsuccessful bid. Within this categorization, although targets that are subsequently taken over realize a significant permanent positive revaluation of their shares, stock prices of target firms that remain independent return to their pre-tender offer price within one or two years. Bradley, Desai & Kim, supra note 10, at 193-94. On the basis of their findings, Bradley, Desai, and Kim conclude that "the synergy hypothesis is a better description of the nature of tender offers than the information hypothesis." Id. at 205. Of course, an equally plausible explanation is that after two years the probability of a takeover is correctly perceived to have diminished to the same value as before the unsuccessful tender offer was rumored or announced. A worthwhile empirical study that might distinguish between the two hypotheses would be to determine if abnormal gains could be realized by investing in the stock of targets of unsuccessful tender offers two years after the unsuccessful tender offer.

[66] A "toe-hold" acquisition is an acquisition of a small percentage of a company's shares. Under § 13(d)(1) of the Williams Act, 15 U.S.C. § 78m(d)(1) (1982), an acquisition of shares must be disclosed within 10 days after 5% of the outstanding stock is acquired.

[67] The term "greenmail" is used to describe the payments by firms to individual shareholders ("greenmailers") to repurchase their blocks of common stock. These payments are made by target management to reduce the threat of a hostile tender offer or proxy fight. One survey

Yet another problem relating to the efficiency of the market with respect to the acquisition component of share value is that acquisition decisions are substantially within the control of the participants, whether acquirers or targets. While corporate managers cannot simply decide to increase earnings per share, the ratio upon which the dividend decision ultimately depends, they can decide whether to agree to a merger. Furthermore, the relationship between merger activity and economic conditions is not as well understood as the relationship between the level of corporate profits and prevailing economic conditions,[69] thus depriving market analysts of an important tool with which to estimate the probability factor of the acquisition value component.

For all these reasons, then, even if the market is acknowledged to be efficient with respect to earnings and dividend information, it is likely to be less efficient in determining acquisition probabilities and values. Put differently, it may be that the "semi-strong" form of the efficient capital markets hypothesis leads to accurate valuation of shares with respect to dividends and earnings, whereas accurate valuation with respect to possi-

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estimated that from January 1979 to March 1984, the total premium above market price paid for such repurchases exceeded $1 billion. See Office of the Chief Economist of the SEC, The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,713, at 87,173 & n.1 (Sept. 11, 1984) (citing Kidder Peabody study). The SEC's study concluded that the "overall impact of targeted share repurchases on the wealth of nonparticipating target shareholders is negative." Id. at 87,174. This study on greenmail supported the SEC's earlier proposal to prohibit repurchases of more than % of outstanding securities at a premium from any individual holder without shareholder approval. See id. Payments of greenmail were found particularly contrary to target shareholder interests when they terminated contests for corporate control. See also Bradley & Rosenzweig, Defensive Stock Repurchases, 99 Harv. L. Rev. 1377 (1986); Bradley & Wakeman, The Wealth Effects of Targeted Share Repurchases, 11 J. Fin. Econ. 301 (1983); Dann & DeAngelo, Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control, 11 J. Fin. Econ. 275 (1983); Gordon & Kornhauser, Takeover Defense Tactics: A Comment on Two Models, 96 Yale L.J. (forthcoming 1986); Macey & McChesney, A Theoretical Analysis of Corporate Greenmail, 95 Yale L.J. 13 (1985).

[68] Of course, there may be certain kinds of acquisition-related research that are conducted by a wide spectrum of investors, not just greenmailers and prospective acquirers or their investment bankers. For example, many analysts determine the liquidative or "bust-up" value of corporations. Thus, the market may reflect value which will arise from acquisitions undertaken for the purpose of liquidating a company for more than its going concern value.

[69] One of the few studies on mergers and economic conditions is R. Nelson, Merger Movements in American Industry 1895-1956 (1959). For a brief assessment of merger activity and its relation to changes in the economy, see CEA Annual Report, supra note 6, at 192-95 (reporting that, between 1981 and 1983, over 50% of the transaction value of mergers and acquisitions were accounted for by five industries (petroleum, banking and finance, insurance, mining and minerals, and food processing) which combine for less than 10% of the national income).

ble acquisition opportunities may require that the "strong" form of the efficient capital markets hypothesis be true, that is, that the market fully reflect insider information as well as publicly available information.[70] But to date, there has been no empirical demonstration of the strong form of the hypothesis.[71]

These limitations on the evidence and theory of market efficiency put into perspective the demands of a target's management for a large premium over market price when faced with a proposed merger or tender offer. Such demands do not necessarily rest on a claim that the market is, in some broad sense, inefficient and the stock undervalued. Rather, the claim may be only that the market price does not reflect value which may arise from the acquisition, and that the shareholders of the acquired company are entitled to some, or perhaps even all, of that value. Of course, merely because such shareholders want more for their shares does not mean either that the shareholders as a group will be able to insist on the higher payment for their shares, or that society has an interest in recognizing and protecting such a claim.

II

THE DISTRIBUTION OF GAINS IN CORPORATE ACQUISITIONS

A. Empirical Evidence on the Gains in Mergers and Tender Offers

Stock price studies have indicated that both tender offers and mergers are value-creating transactions,[72] although the evidence is not unequivocal.[73] The choice of the acquisition procedure should not significantly affect the total gains available,[74] but it might affect the allocation between the two firms. Simply because the stock trades for less than its acquisition value does not imply that a majority or controlling interest can be acquired for its trading price in a publicly announced tender offer, nor does it tell us under what circumstances management of the target could negotiate a merger price substantially above that trading price. The question we will want to address is, given an acquisition value to a particular acquiring firm of *A* and an aggregate stock market value of the target firm of *V*, do the merger and tender offer procedures result in different acquisition prices *S*?

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[70] Fama, supra note 42, identifies three "forms" of the efficient capital market hypothesis. "Weak" form tests demonstrated that the market is efficient with respect to the history of securities prices, that is, that no trading profits can be earned by using strategies based on past prices. Such tests indicate that technical analysis, see note 63 supra, will not yield a positive return. The "semi-strong" claim of market efficiency posits that the market prices quickly incorporate all *publicly* available information. Tests which proved this claim suggest that trading profits cannot be earned on fundamental analysis, see note 63 supra. Finally, the "strong" form claims that the market price fully reflects not only public information but also information that is not publicly available, such as information only available to insiders.

[71] There is some proof of a sort of quasi-strong form: that sophisticated investors with the best access to information, namely those who manage investment funds, cannot outperform the market. Insiders and market makers, however, do apparently outperform the market, suggesting that the market prices do not fully reflect information possessed by those groups. See Gilson & Kraakman, supra note 46, at 556 n.27.

[72] See, e.g., Asquith, Merger Bids, Uncertainty, and Stockholder Returns, 11 J. Fin. Econ. 51, 82 (1983) (mergers); Bradley, Interfirm Tender Offers and the Market for Corporate Control, 53 J. Bus. 345, 375 (1980) (tender offers); Dodd & Ruback, supra note 35, at 372 (tender offers); Mandelker, Risk and Return: The Case of Merging Firms, 1 J. Fin. Econ. 303, 329 (1974) (mergers).

[73] See Malatesta, The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms, 11 J. Fin. Econ. 155 (1983) (concluding that the long-run wealth effect of

1. The Amount of Gains

In comparing combinations by tender offer and merger, we should first address the somewhat surprising observation that, based on stock price analysis, on average, greater gain is associated with tender offers than with mergers. While the average excess return in mergers is about 20% for the target and nothing for the bidder, in tender offers it is 30% for the target and 4% for the bidder.[75] Since the bidder is usually (but not always) substantially larger than the target, the 4% increase in value

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events leading up to a merger is significantly negative for acquiring firms, and negative, but not significant, for acquired firms); *Ruback*, The Conoco Takeover and Stockholder Returns, Sloan Mgmt. Rev., Winter 1982, at 13 (suggesting substantial negative returns in the case of the DuPont takeover of Conoco).

[74] Since a hostile tender offer probably entails substantially more costs in terms of integrating the two firms, it might be true that generally smaller gains are available as a result of combinations through hostile tender offers than negotiated mergers. On the other hand, negotiated mergers might require more in the way of side payments to the target's management to get their agreement and cooperation. Both these costs, to the extent they exist, are probably small in relation to overall values arising from the transaction, and since they have opposite effects they probably net out to a very small difference between mergers and tender offers.

[75] Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5, 7 (1983). The figures represent "cumulative average residuals" (CAR's), which are changes in stock price adjusted to eliminate the effects of marketwide price changes. The expected price change is determined by application of the Capital Asset Pricing Model. See generally Brown & Warner, Measuring Security Price Performance, 8 J. Fin. Econ. 205, 207-11 (1980); Schwert, Using Financial Data to Measure Effects of Regulation, 24 J.L. & Econ. 121, 124-29 (1981). See also Gordon & Kornhauser, supra note 42, at 773-86. The Jensen & Ruback figures are not the result of any single empirical study, but rather represent a combination and summary of previous empirical studies. The actual figures for the studies cited by Jensen and Ruback vary widely, and depend on both the period covered, the "sample period," which in some cases included both pre- and post-Williams Act statistics, and the "event period," which ranged from a couple of days before and after public announcement to 40 days before through 20 days after. Generally speaking, the measured price increase grew as the event period expanded, and was greater for more recent sample periods. In the case of targets of successful tender offers, the price increases ranged from 16.9% to 34.1%, whereas the increases for targets of successful mergers ranged from 6.2% to 34.0%. The increases in bidder stock price in successful tender offers ranged from 2.4% to 6.7% and in mergers from 7.2% to 3.48%. Jensen & Ruback, supra, at 11-13.

of the bidder may really be of the same order of magnitude as the increase in value of the target, implying that the gains from tender offers may typically be two to three times the gains associated with mergers.[76] It does not seem possible that the difference in acquisition procedure should affect the total amount of gain from the transaction. The more likely explanation is that tender offers are for some reason used in cases in which the gain from the acquisition is substantially greater than in mergers.[77]

Why should this be so? One explanation might be that the gains associated with tender offers are qualitatively different from those associated with mergers, and that this qualitative difference is associated with a quantitative difference in the magnitude of the gains. For instance, Professors Easterbrook and Fischel have hypothesized that tender offers are used primarily when the acquirer faces a hostile, inefficient target management, whereas mergers are used when synergistic or other gains (which typically require the retention of target management) are produced by the combination of the two firms.[78] There is no direct evidence to support this hypothesis, however,[79] and the anecdotal evidence indicates that many of the firms acquired by tender offer are well managed. Furthermore, this hypothesis is inconsistent with share price data on proxy contests for corporate control. These contests, which should create gains typical of a change of control in the absence of interfirm synergies, produce on average only an 8% abnormal percentage change in stock price.[80] Thus, if tender offers were used, like proxy contests, primarily to oust inefficient management, we would expect the gains from tender offers to be much smaller. Of course, one might further speculate that tender offers are used where there are both synergistic gains to be realized and target management is inefficient, producing a summation of the type of gains from mergers and proxy contests.

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[76] The relationship between relative firm size and acquisition gains has not received much attention in the literature. One study did conclude that percentage abnormal changes in the bidder's stock depended on the relative size of the target. Where the target's size in a merger was less than 10% of the acquirer's size, the acquirer's stock showed an average abnormal increase of 1.7%. Where the target's size was 10% or more of the acquirer's size, the corresponding increase was 4.1%. Asquith, Bruner & Mullins, The Gains to Bidding Firms from Merger, 11 J. Fin. Econ. 121, 132 (1983); see also Malatesta, supra note 73, at 171 (although percentage change for acquiring firms in mergers and tender offers was not significant and even changed sign depending on the event interval, actual dollar gains averaged $13.8 million for acquiring firms and $18.6 million for acquired firms); note 88 infra. This interpretation of the division of gains in acquisitions finds indirect support in a recent study of gains in joint ventures. The study found that the percentage increase for large firms was about half that for small firms, but that the amount of gains which went to large and small firms was about equal (large firms received somewhat more, but this finding might reflect the fact that the large firms participated in larger joint ventures). McConnell & Nantell, Corporate Combinations and Common Stock Returns: The Case of Joint Ventures, 40 J. Fin. 519, 530-31 (1985).

It is somewhat puzzling that joint ventures apparently result in an equal sharing of gains whereas mergers, which are also negotiated between the managements of the two firms, result in the gains being distributed overwhelmingly to the acquired corporation. One explanation is the bargaining advantage enjoyed by the target management in the context of a merger negotiation. See text accompanying notes 104-08 infra. Such an advantage would not exist with respect to joint venture negotiations since both managements will retain their positions, and control over the expansion will be shared rather than exclusive.

[77] An alternative explanation is that the dollar amounts of gains are similar, but that mergers involve larger firms than tender offers. This explanation does not seem supported by merger and tender offer practice, however.

[78] See, e.g., Easterbrook & Fischel, Proper Role, supra note 6, at 1168-69.

[79] Even the stock price studies upon which Easterbrook and Fischel rely so heavily, see note 177 infra, do not support this suggested qualitative difference in gains from mergers and tender offers. The stock price studies show that acquired firms post substantial abnormal negative returns prior to being taken over, thus indicating that acquired firms were inefficiently

The more plausible explanation is straightforward: tender offers are more likely to be utilized when the gains are perceived to be greater. If, for example, transaction costs are higher in tender offers, they may be feasible only where the gains are sufficiently large. Or the increased riskiness of the returns from tender offers, in view of the lack of inside information[81] and the pressured atmosphere in which decisions are made, may require a greater expected return.

2. *The Distribution of Gains*

If the stock price studies are correct, there is not only a difference in the size of gains in mergers and tender offers, but also a difference in their distribution. Whereas none of the gains appear to be allocated to acquirers in mergers, successful bidders in tender offers realize a 4% increase in value, a figure that given the larger size of bidders probably represents 20% to 50% of the combinative gains.[82]

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managed. Easterbrook & Fischel, Proper Role, supra note 6, at 1187-88. But see note 177 infra (noting that the stock price studies are contradicted by other data and do not support the inefficient management hypothesis). But the stock price literature includes studies of firms acquired by merger as well as those acquired by tender offer, see Easterbrook & Fischel, Proper Role, supra note 6, at 1187 n.69, and both types of firms are found to underperform the market prior to acquisition. If the qualitative difference implicitly postulated by Easterbrook and Fischel existed, we would expect to find only tender offer targets underperforming the market, not merger targets as well.

[80] Dodd & Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. Fin. Econ. 401, 416 (1983).

[81] In a merger, in contrast, "[t]he negotiation process typically involves transferring to the offeror substantial amounts of nonpublic information concerning the target [that] reduces uncertainty about the future return on the acquisition and hence increases the value of the investment to the offeror." Gilson, supra note 6, at 830-31 (footnotes omitted). Nonpublic information disclosed during negotiations may include proprietary product information, clarifications to financial statements, updated financial statements, information about pending litigation and administrative proceedings, the current state of labor relations, and options to acquire or lease properties. See id. at 830 n.112.

[82] See note 76 and accompanying text supra. One study has argued that the increase in the bidder shares may reflect only a signalling difference between a merger and a tender offer.

It should be noted that the figures in both tender offers and mergers may understate the amount of gains from the transaction that go to acquirers. Since bidders are often clearly embarked upon acquisition programs, the market can identify them in advance.[83] The gains expected to arise from future acquisitions will therefore already be incorporated into their price prior to the transaction.[84] The response of the market to announcement of an acquisition will be merely an adjustment in price to reflect the difference between the gains that are expected now that the specific transaction is known and the gains that were more generally expected from the acquisition program. This may explain why an acquirer's stock price falls in the case of an unsuccessful merger.[85] Targets, on the other hand, are not similarly self-identified in advance,[86] and increases in their value are unexpected and thus abnormal.

The above figures also primarily reflect tender offers subsequent to the Williams Act, and it seems beyond dispute that the regulatory scheme applied to tender offers can affect the distribution of the gains realized.[87] There is some evidence that unregulated tender offers produce

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DeAngelo, DeAngelo & Rice, Going Private: Minority Freezeouts and Stockholder Wealth, 27 J.L. & Econ. 367, 378 n.27 (1984). Tender offers are typically for cash, whereas mergers are more often for an exchange of stock. The choice of a cash transaction over an exchange transaction indicates bidder management's view that its stock is undervalued, and the reverse choice indicates the belief that its stock is overvalued. The market responds to this information, at least in the case of a cash tender offer, by upwardly revaluing the stock price of the acquirer. A revaluation on this basis would have nothing to do with gains arising from the corporate combination itself.

[83] Schipper & Thompson, Evidence on the Capitalized Value of Merger Activity for Acquiring Firms, 11 J. Fin. Econ. 85, 109-10 (1983). But cf. Malatesta, supra note 73, at 180 (concluding that acquiring firms show significant negative returns in the five years preceding merger announcements).

[84] Schipper & Thompson, supra note 83, at 118. This conclusion was based on a study of the stock prices of firms which announced acquisition programs. A different study concluded that merger bids were positive net present value investments, but that in a sequence of merger bids each merger increased the value by about the same amount, suggesting that the value of a merger program was not capitalized into the firm's value at the beginning of such a program. Asquith, Bruner & Mullins, supra note 76, at 138.

[85] See Bradley, Desai & Kim, supra note 13, at 186.

[86] Occasionally a company will announce its interest in being acquired, either by making a public announcement, having its investment banker make discrete inquiries, or perhaps even initiating a tender offer auction by commencing a leveraged buyout. Targets are acquired only once, however, and typically the public disclosure of the interest in being acquired will come within a relatively short time period before more definite information emerges. The stock price studies, whose event periods typically begin at least a month before the announcement of an acquisition, would tend to merge any stock increase attributable to the public disclosure with the gain associated with the transaction. Even if some of the gain is reflected in the price prior to the acquisition, this amount will be comparatively less than the analogous gain of an acquirer which is engaged in a general acquisition program.

[87] See, e.g., Schipper & Thompson, supra note 83, at 118 (finding a negative effect on bidder firm value resulting from four regulatory changes relating to mergers and acquisitions adopted from 1967 to 1970).

an even greater disparity between mergers and tender offers with respect to the distribution of gains. One study found that prior to the Williams Act tender offer targets realized on average a 22% increase and the bidders a 9% increase, and that after the Williams Act targets realized a 40% increase and bidders a 6% increase.[88] The Williams Act thus apparently brought the distribution of the gains in tender offers closer to the distribution that occurs in mergers. Even under the Williams Act, however, the distributional pattern of tender offers is superior, from the acquirer's point of view, to that of mergers.[89] One might hypothesize, then, that acquirers choose tender offers when gains are greater because only in those situations is it possible to allocate a significant portion of those gains to the acquirer.

B. The Mechanisms of Corporate Acquisitions

Pending further empirical data, the theory put forth here regarding the division of gains in corporate acquisitions must be regarded as tentative.[90] But the existing evidence, while sketchy, does suggest a difference in the distribution of gains between the acquired and acquiring corporations in mergers and tenders offers.

What would explain this difference in the allocation of gains in tender offers and mergers? A merger, as explained above, is a bargaining transaction, the terms of which are negotiated by the managements of the merging firms. A tender offer, on the other hand, is a fixed offer by a firm to numerous sellers who do not generally communicate or coordinate their decisions and who are accustomed to acting as price takers.[91] Per-

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[88] Jarrell & Bradley, The Economic Effects of Federal and State Regulations of Cash Tender Offers, 23 J.L. & Econ. 371, 389, 395 (1980). Jarrell and Bradley found that state tender offer regulation further reduced the bidder's abnormal return to 4%. Id. at 395. Another study found a similar reduction in abnormal returns to bidders: from 4.4% prior to the Williams Act to 1.7% after the Williams Act. Asquith, Bruner & Mullins, supra note 76, at 133. See also Schipper & Thompson, The Impact of Merger-Related Regulations on the Shareholders of Acquiring Firms, 21 J. Acct. Research 184, 215-16 (1983) (concluding that the Williams Act diminished the value of acquiring firms by 6%).

If one assumes that the average gains available from such transactions remained constant, the relationship between the average target size and average bidder size could be derived from the figures provided in text. An 18% increase in the amount of gains allocated to targets resulted in a 3% decrease in the amount allocated to bidders. This suggests that bidders on average are about six times the size of targets. If this is so, then prior to the Williams Act the vast majority (71%) of the amount of gains went to the bidders, whereas after the Williams Act roughly half (47%) of the gains went to the bidders.

[89] While the Williams Act initially appeared to curtail the number of acquisitions by tender offer, that is no longer the case. For a list of the number of tender offers during the fiscal years 1965-1982, see Coffee, supra note 11, at 1178 n.95.

[90] As Jensen and Ruback noted in 1983, "no well-developed theory exists that determines the division of the net benefits between target and bidding firms." Jensen & Ruback, supra note 75, at 29.

[91] While shareholders coordinate their activities insofar as the management of their collec-

haps these distinct characteristics of tender offers and mergers explain the differing distribution of gains.

1. The Bargaining Mechanism

Unfortunately, there exists no widely accepted comprehensive theory of bargaining,[92] so it is not possible from a theoretical viewpoint to predict the distribution of gains in bargained-for merger agreements. Both theoretical[93] and some experimental[94] work have indicated, how-

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tive investment is concerned, they do not generally coordinate their decisions to dispose of or acquire that investment. One commentator has identified this as the primary problem of tender offers—particularly two-tiered tender offers—and has proposed charter amendments allowing for coordinated shareholder actions as a solution. See Carney, Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties, 1983 Am. B. Found. Research J. 341.

[92] The seminal article in the field is Nash, The Bargaining Problem, 18 Econometrica 155 (1950). Earlier efforts include von Neumann & Morgenstern, Theory of Games and Economic Behavior (First Science Edition Printing 1964). Von Neumann and Morgenstern treat bargaining as a nonzero-sum two-person game. Id. at 555-57. Nash develops a model on the additional assumptions that (1) "no action taken by one of the individuals without the consent of the other can affect the well-being of the other one"; (2) the individuals are equal in "bargaining skill"; and (3) each individual has available complete information, including an accurate assessment of the tastes and preferences of the other individual. Nash, supra, at 155.

Somewhat distinct from the game theoretic approach to bargaining is an economic approach that finds its origins in analyses of labor-management negotiations, and in particular in F. Zeuthen, Problems of Monopoly and Economic Warfare (1930 & photo. reprint 1968). On the development of bargaining theory and the relationship between economic and game theoretic models, see Bargaining: Formal Theories of Negotiation 131-44, 303-07 (O. Young ed. 1975) (editor's introductions to Parts II & III). In addition to the theoretical literature, there is a wealth of psychological and "how to" literature. See, e.g., sources cited in Menkel-Meadow, Toward Another View of Legal Negotiation: The Structure of Problem Solving, 31 UCLA L. Rev. 754, 755-58 & nn.1-5 (1984).

It should be noted that bargaining lacks not only a generally accepted theory but also a generally accepted definition. The range of definitions is extremely broad. Some definitions require complete information; others require incomplete information. Some definitions allow for bargaining in zero-sum conflict situations; others do not. See Young, Strategic Interaction and Bargaining, in Bargaining: Formal Theories of Negotiation 1, 4-5 (O. Young ed. 1975). Young adopts the following definition: "[B]argaining is the manipulation of the information of others in the interests of improving the outcome for one's self under conditions of strategic interaction." Bargaining: Formal Theories of Negotiation, supra, at 304 (editor's introduction to Part III). Rejection of the thesis that bargaining occurs in situations where perfect information is available derives from the insight that, if the parties have such information, only one outcome is possible. Whether or not one accepts this insight, it remains of substantial interest to see how preferences and strategic options, even when fully known to both parties, affect the agreements which are made.

[93] See R. Luce & H. Raiffa, Games and Decisions 143-45 (1957); Nash, supra note 92; cf. F. Zeuthen, supra note 92, at 115-21 (theoretical analysis of labor negotiations suggesting that rational workers and employers will meet midway). Of course, it is not really "gains" that will be divided equally but utility. In other words, bargaining in a nonzero-sum or constant-sum situation will result in each player increasing his utility by the same amount. If the players attach different utilities to monetary wealth, then even a purely monetary gain will be split unevenly.

[94] See, e.g., Neslin & Greenhalgh, Nash's Theory of Cooperative Games as a Predictor of

ever, that in the absence of other differences, gains will be divided roughly equally. This is as one would expect under the assumptions of complete information[95] and equal bargaining power.[96] There is no reason for one party to accept an arrangement which is more generous to the other party, or to expect the other party, whom he must assume also to be a rational utility maximizing individual, to accept such an arrangement.[97] But bargaining in the real world rarely takes place under conditions of complete information or equal bargaining power.

Among the most important factors affecting the outcome of bargaining are the expectations of the parties.[98] If one of the parties expects to achieve a certain outcome on the basis of prior experience in similar situations, he will not be inclined to accept a less favorable outcome. Put

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the Outcomes of Buyer-Seller Negotiations: An Experiment in Media Purchasing, 20 J. Marketing Research 368 (1983) (providing experimental support for the bargaining model presented in Nash, supra note 92).

[95] Complete information includes not only information about the value of the subject matter of the bargaining, but also information about one's own and one's adversary's preferences. See Bishop, Game-Theoretic Analyses of Bargaining, 77 Q.J. Econ. 559, 560 (1963); Nash, Two-Person Cooperative Games, 21 Econometrica 128, 130 (1953). While game theoretic approaches to bargaining have generally developed models on the assumption that complete information is available, others have specified incomplete information as a necessary condition for bargaining. See note 92 supra.

[96] There is no generally accepted definition of bargaining power, and it is a difficult concept to incorporate in theoretical models and experiments. While differences in information contribute to what we might call bargaining power, differences in the ability to manipulate that information and respond to the other party's manipulations would also fall within this rubric. Bargaining power might also be defined to include the parties' relative preferences with respect to reaching or not reaching an agreement. Thus, we might say, for example, that a party who had only a mild preference for reaching an agreement had greater bargaining power than a party who had a very strong preference. Another important variable, which one might conceptualize as bargaining power, is the costs of bargaining—particularly where such costs are time-dependent. If one party's costs per unit of time are high and the other party's are low, the party with the higher costs will be pressured to reach an agreement quickly. For a formal presentation of this point, see Rubinstein, Perfect Equilibrium in a Bargaining Model, 50 Econometrica 97 (1982).

[97] In the case of corporate merger negotiations, of course, the parties are not individuals but firms. Modeling bargaining between firms (or groups) as opposed to individuals is more complex unless one assumes that firms also have utility functions. See A. Coddington, Theories of the Bargaining Process 6 (1968); J. Pen, The Wage Rate Under Collective Bargaining 47-60 (1959). A more realistic view is that a firm's decisionmakers and bargainers, who are legally agents of the firm and, to some extent, serve at the pleasure of their principal, have utility functions that take into account the utility functions of others, in particular shareholders. Shareholders can be viewed as having relatively simple utility functions that depend solely on the value of their shares (although differential taxation of unrealized capital gains, realized capital gains, and dividends complicates this generalization). Managerial welfare can be expected to depend largely on shareholder welfare, especially if managerial compensation is closely tied to shareholder welfare, although some studies show managerial welfare to be linked more closely to firm size than to profitability, see text accompanying note 28 supra.

[98] Roth & Schoumaker, Expectations and Reputations in Bargaining: An Experimental Study, 73 Am. Econ. Rev. 362 (1983).

somewhat differently, prior results help define both what is possible and what is perceived to be fair. Expectations may be defined in terms of either a consistent premium or a consistent distribution of the gain resulting from the transaction.[99] These expectations will play a particularly important role where information is incomplete. Thus, the very consistency of premia generally paid to shareholders of acquired firms may be an important determinant of the allocation of gains. If target shareholders or managers expect a 20% premium in acquisitions, then the premiums paid may cluster around that figure even though the total amount of gains in individual transactions varies widely.[100]

Although this analysis is not directly applicable to decision making outside the bargaining context, it does suggest an additional reason why tender offers tend to be used when the prospective gains are large. Even under the Williams Act, the bidder and target in a tender offer share relatively little information. By contrast, the parties to a merger disclose much information.[101] An acquirer who believes that the gains which will be produced by the combination are greater than the average gains associated with such transactions may, in order to conceal this very belief, prefer to use the mechanism in which there is less sharing of information. Target shareholders, not knowing about the greater gain associated with the transaction, will tender for the expected merger premium (in terms of a percentage over the prior share price).[102] If the acquirer chooses to negotiate a merger, on the other hand, and if the parties do tend to gain more information in the course of a merger negotiation, then the acquirer might have to meet the distributional expectations (in the sense of a percentage of the gains) of the target's management.

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[99] If there is complete information, expectations should focus on the division of gains rather than on the premium. Where the amount of total gain is unknown to the shareholders, however, the average premium may serve as an approximation of the usual "share."

[100] The development of such expectations may have significant collateral effects. Shareholders, for example, may be unwilling to tender to, and management may credibly oppose, offers at a lesser premium. This significantly diminishes the value of the tender offer as a mechanism for merger when gains are smaller, as might be the case where management is simply less efficient.

This argument that shareholder expectations may determine a minimum premium for a successful tender offer should be distinguished from the more general argument that the supply curve for shares in a given firm is upward sloping, so that a significant premium above market is necessary to elicit more than the number of shares that would normally be traded in a given period. See Coffee, supra note 11, at 1184-85. Professors Easterbrook and Fischel, in contrast, have assumed that the supply curve is flat because investors are interested only in assembling an efficiently diversified portfolio and there are perfect substitutions for the shares of any given firm. Easterbrook & Fischel, Corporate Control, supra note 6, at 726-27.

[101] See note 81 supra.

[102] In fact, prior to the Williams Act, tender offer premiums were very close to, or even less than, merger premiums. Compare Hayes & Taussig, Tactics of Cash Takeover Bids, Harv. Bus. Rev., Mar.-Apr. 1967, at 135, 140 (reporting average premium of 16% in tender offers with a range from 0% to 44%) with Mandelker, supra note 72 (reporting average premium of 14% in mergers from 1926-1968).

In addition to the expectations of the parties, other important determinants of bargaining outcomes are the parties' preferences and strategic options.[103] Since managers of the acquired company are likely to be displaced[104] (or at least have their power substantially diminished), they have a strong preference not to be acquired. Somewhat paradoxically, this preference may put them in a strong bargaining position.[105] The acquirer's managers, in contrast, may have a strong preference that the acquisition go through, in part because of sunk costs[106] and in part because they will benefit personally by their firm's expansion.[107] This preference also contributes to the bargaining advantage of the target. Accordingly, the managers of the target generally will be far more willing to risk a conflict that will preclude an agreement than will the managers of the acquirer. As a result, in most mergers and at any given stage of negotiation, the acquirer will be far more likely to make concessions.[108]

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[103] See Nash, supra note 95, at 153; Roth & Schoumaker, supra note 98, at 362.

[104] See Coffee, supra note 11, at 1150 n.8 (citing survey finding that 52% of the target company executives leave within three years). An earlier study produced somewhat conflicting results, finding that two-thirds of acquiring companies grant autonomy to the target with respect to operating decisions, with the result that little reorganization of management takes place. J. Markham, Conglomerate Enterprise and Public Policy 85 (1973).

[105] The paradox raises the question whether truly loyal managers can exploit a bargaining advantage which to some extent derives from disloyalty (in that the managers are pursuing their own interest in maintaining their positions rather than the stockholders' interests). Shareholders interested in maximizing the price of the firm on sale may actually prefer managers who are somewhat disloyal. This analysis of "bargaining resolve" in the context of merger negotiations suggests that "golden parachutes" (contracts which provide large payments to managers if the firm is acquired) may not be desirable from the shareholder perspective. The traditional argument for such contracts is that they will make management neutral as between the survival of the firm as an independent entity and its acquisition. See, e.g., Morrison, Those Executive Bailout Deals, Fortune, Dec. 13, 1982, at 82. But the willingness of management to be acquired will diminish its inclination to bargain strongly over terms. Thus, one could expect golden parachutes to lead not only to less frequent management opposition, but also to lower acquisition prices.

[106] The "sunk costs" argument is really an argument about the marginal returns from the incremental investment made after the sunk costs are incurred. If, for example, a $100 investment will yield a $10 return representing the required rate of return of 10%, but half the costs must be invested in a form which does not promise any return (e.g., information costs), the return from the remaining $50 investment is 20%. If the chance to realize on the investment does not materialize, the firm will lose $50. But it could be convinced to spend up to $100 more on the investment since that additional investment will still yield 10%, although overall the yield on the investment would be only 6.7% ($10 on $150). See Shubik, The Dollar Auction Game: A Paradox in Noncooperative Behavior and Escalation, 15 J. Conflict Resolution 109 (1971); Carney, supra note 91, at 371 n.143.

[107] See text accompanying note 28 supra.

[108] See Harsanyi, Bargaining and Conflict Situations in the Light of a New Approach to Game Theory, 55 Am. Econ. Rev. (Papers and Proceedings) 447, 454 (1965) ("the [player] more willing to risk a conflict . . . can reasonably expect a concession from the other player, while the one less willing to risk a conflict cannot expect a concession from his opponent and has to make himself a concession if a conflict is to be avoided"); see also F. Zeuthen, supra note 92, at 106-21 (discussing willingness to risk conflict and make concessions in the context of labor negotiations).

In terms of strategic options, the most important factor is the availability of other merger partners for both the acquirer and the target. If other firms are willing to pay a premium to acquire the target, or if other firms providing similar acquisition opportunities are available, bargaining will be forced within competitive parameters. If, for example, the target would be a valuable acquisition to a large number of potential acquirers, it will have as its reservation price (the price below which it would not agree to sell) the best offer it thinks it can get from another bidder. If the target is bargaining with the acquirer who values it most highly, its reservation price will be the second best available price (the value to the highest valuing bidder being the best price).

The ability of the target to obtain a price higher than the reservation price will depend in part on the acquisition alternatives open to the acquirer. An acquirer in a merger negotiation may not be able successfully to offer a nominal amount above the second best price. Such an offer would, from the bargaining viewpoint of the target, set only the minimum price; the target may insist on an equal distribution of the gains in excess of that price. Thus, for example, if the target's stock is trading at $50, and there are several companies willing to pay $65, but only one company which could pay $100, the $65 will set the floor and the $100 the ceiling of the negotiation. But if the acquirer can threaten a tender offer in which the expected price will be only nominally above (or even below[109]) the second best offer, the bargaining strength of the target will be severely limited. On balance, however, a theoretical analysis of bargaining in the merger context comports well with the empirical evidence that virtually all gains go to the acquired company's shareholders.

2. *The Tender Offer Mechanism*

How do tender offers differ from bargaining? We will eventually need to consider two types of tender offers: competitive tender offers, where there is more than one bidder, and noncompetitive tender offers, where there is but one bidder. For now, however, I consider only noncompetitive offers. These include almost all unregulated tender offers,[110] which need be open only for an extremely short period of time, depriving rival bidders of the time usually necessary to formulate a competing offer.[111]

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[109] As discussed below, the price that results from a tender offer auction will be affected by the willingness of other bidders to enter the auction. If the other bidders realize that the first bidder is the potential high bidder, they will have no incentive to enter the auction, enabling the first bidder successfully to tender at a price below the $65 that was thought to constitute the second best offer. See text accompanying notes 145-47 infra.

[110] By "unregulated tender offers," I mean offers that take place in a pre-Williams Act setting, where bidders need not make disclosure of their pre-tender holdings, keep their offers

No shareholder will sell for less than the prevailing market price, but will the shareholder who believes he cannot affect the outcome of the transaction tender to a noncompetitive offer for any price above market? Writers on tender offers have made much of certain public choice and game theory problems, in particular the free rider problem[112] and the prisoner's dilemma,[113] in evaluating the strategic posture of a target shareholder in this position. As I hope to show, however, in focusing attention only on the target's shareholders to the neglect of the bidder, these particular game theory analogies are somewhat inapt.

A free rider problem has been said to arise if the shareholder could continue to participate in the enterprise even if the offer were successful. In such a case, the shareholder might not tender at any price below the full acquisition value since that is presumably the value of the shares after a successful tender offer.[114] Under this rationale, no tender offer will succeed at less than acquisition value since each shareholder will hope to be a free rider at the expense of fellow shareholders who tender. This problem is completely eliminated, however, by the threat of a freezeout merger at or below the tender offer price.[115] The threat of a freezeout dashes any shareholder's hope of remaining part of the enterprise and destroys any incentive to withhold shares while others tender. Under

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open for 20 days, or, if they decide to increase their bid, pay the higher price even to shareholders who tendered at the lower price. See note 34 supra and notes 111, 120 infra.

[111] Prior to the Williams Act, very few tender offers were competitive. A number of commentators have suggested that even under Rule 14e-1(a) of the Williams Act, 17 C.F.R. § 240.14e-1(a) (1985), which requires that a bid be open for 20 business days, there is insufficient time for an auction market to develop. See, e.g., Lowenstein, supra note 7, at 322-26.

[112] See, e.g., Easterbrook & Fischel, Corporate Control, supra note 6, at 710-11; Grossman & Hart, Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation, 11 Bell J. Econ. 42 (1980).

[113] See, e.g., Carney, supra note 91, at 366-67; Coffee, supra note 11, at 1187 n.116, 1205.

[114] Grossman & Hart, supra note 112, at 59 (concluding that, in the absence of a freezeout merger, no shareholder will tender unless the bid price is equal to the value of the firm in the hands of the bidder). Since offers entail transaction costs, and the bidder must pay the full future value of the firm to present shareholders, an offer would succeed only at a loss and therefore no offers would be made. Id. at 45.

[115] Professors Easterbrook and Fischel suggest that if the follow-up merger price is required to be at the tender offer price, shareholders will still attempt to free ride on the "hope" that they will not be frozen out but that other shareholders will tender and the bid will be successful. Easterbrook & Fischel, Corporate Control, supra note 6, at 710-11. This analysis is unrealistic. If the shares would be worth more, then the bidder undoubtedly will freeze the shareholders out and they will receive only the offered price. And if each shareholder adopted Easterbrook and Fischel's logic, the bid would not succeed. Since each shareholder wants the bid to succeed and will almost certainly receive no more than the bid price if it is successful, each shareholder will vote his true preferences.

these circumstances, every shareholder who wants the offer to succeed will tender. Thus, one would expect noncompetitive tender offers for only a very small premium above market to attract a majority of the outstanding shares, even where the shareholder is not faced with the prospect of being frozen out at a price below the tender offer price. Experience prior to the Williams Act bears out this expectation.[116]

A tendering shareholder may also be a free rider. Certain tender offer scenarios, particularly front-end loaded transactions,[117] have been described as a prisoner's dilemma: a game situation where it is advantageous for one player not to cooperate with the other player regardless of what the other player does, but where mutual cooperation yields a higher payoff than does mutual lack of cooperation.[118] Consider, for example, a combination between firms *A* and *B* which would produce unique synergistic gains equivalent to $40 per share of firm *B*, whose stock trades for $60. The maximum price *A* would be willing to pay is $100; the minimum acceptable price to *B* is marginally above $60. How will the gain be allocated in the context of a stock market? Suppose *A* makes a tender offer at $70 per share. *B*'s shareholders might suspect that, if nobody tenders, *A* will raise its offer to $100. By making its offer unconditional,

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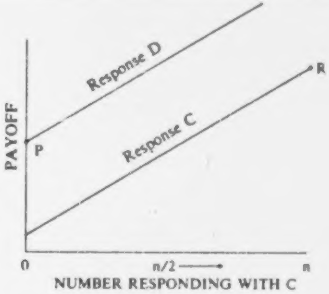
[116] The premium offered in "Saturday Night Specials," see note 18 supra, often amounted to only 15%.

[117] See generally Comment, Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique, 131 U. Pa. L. Rev. 389 (1982). Arguably, virtually any tender offer creates a prisoner's dilemma. The empirical evidence is that the shares of a corporation after the tender offer are worth less than the bid. Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1693, 1713 (1985). This is the result of either the majority's ability to self-deal or its legal right to eliminate the minority pursuant to a freezeout merger. Thus whenever a bid is expected to succeed, the shareholder should tender. Only when a shareholder believes a bid is inadequate *and* expects his fellow shareholders to share that belief and not tender, should a shareholder not tender. Bebchuk's regulatory solution to the problem is to allow shareholders to make two kinds of tenders, approving and disapproving. Id. at 1747-64. See also Radol v. Thomas, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982) (recognizing that "any tender offer is likely to be coercive to some degree" and upholding the use of a front-end loaded two-tiered tender offer). For a more elaborate and formal modeling of shareholder decisionmaking in the face of a tender offer, see L. Bebchuk, A Model of the Outcome of Takeover Bids (Discussion Paper No. 11, Program in Law and Economics, Harvard Law School, Sept. 1985) (on file at New York University Law Review).

[118] On the prisoner's dilemma, see generally A. Rapoport & A. Chammah, Prisoner's Dilemma: A Study in Conflict and Cooperation (1965). The prisoner's dilemma is generally modeled as a two-person game in which two prisoners must decide separately whether to cooperate with each other (by not confessing) or defect (by confessing their crime and receiving a lighter sentence). See P. Samuelson, Economics 506-07 (10th ed. 1976).

The two-person prisoner's dilemma can be generalized to an *n*-person game where the individual player is always better off by not cooperating regardless of the number of other players who cooperate, but all players would be better off if they cooperated. Rather than being represented by the simple box diagram used for the two-person dilemma games, the *n*-person game can be represented graphically as follows:

70-660 - 87 - 29



[*D* represents the payoff from a non-cooperative response; *C* represents the cooperative payoff]

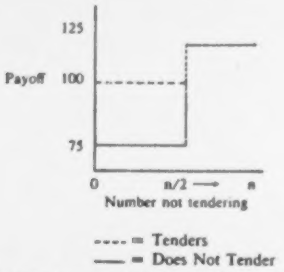
> The vertical distance between the two curves corresponds approximately to the person's *individual interest*, that is, to how much better off he is, regardless of what the other persons are doing, if he makes the D response. The upward slope of the two curves corresponds approximately to the *common interest*, that is, to how much better off everyone is if instead of all acting in Manner D [non-cooperation], they act in Manner C [cooperation].

Kelley & Grzelak, Conflict Between Individual and Common Interest in an N-Person Relationship, 21 J. Personality & Soc. Psychology 190, 191 (1972) (emphasis in original). See also Komorita, A Model of the N-Person Dilemma-Type Game, 12 J. Experimental & Soc. Psychology 357, 358 (1976) (specifying essential conditions for *n*-person prisoner's dilemmas). If all persons pursue their apparent self-interest by not cooperating, the payoff will be *P*, whereas if all persons cooperate the payoff will be the much higher *R*. In the *n*-person game, the individual's and others' activity may vary according to the number who choose a given strategy (such as pollution) or may be a discontinuous function in which there are a limited number of outcomes (typically two) dependent on a minimum number of people choosing that strategy.

This is the case, for example, in tender offers. The following graph represents the payoff functions in a tender offer for $100 per share with a second-step freezeout merger at $75, where the offeror would be willing to raise the offer to $125 if a majority of shares is not tendered. In the latter case, the Williams Act would require that the $125 be paid even to those who had tendered at the initial offer price of $100. See note 120 infra.

however, *A* can avert this scenario.[119] By tendering, a stockholder gets a sure $70 and a chance at $100 if most stockholders do not tender and *A* raises the offered price.[120] If he does not tender on the other hand, all he has is a risky $100 and a sure $60. Since the stockholder does not believe his actions will affect the outcome, the $100 is equally risky, whether or not he tenders. It is therefore in his interest to tender, since the "sure thing" aspect of tendering is greater than the "sure thing" aspect of not tendering. Thus, tendering is likely to be the predominant strategy even in the absence of a coercive freezeout. In this scenario it is the shareholders who tender who are the free riders, since they are hoping to take advantage of fellow shareholders' decisions not to tender without paying the price of increased risk. Of course, if the shareholders could get together and negotiate with *A*, they would likely get at least $80, an even division of the gains, and perhaps as much as $100.

Neither the free rider problem nor the prisoner's dilemma game,[121]



The payoff function is not a classic prisoner's dilemma since the maximum payoff is the same whether or not the person cooperates (does not tender) or defects (tenders). See Komorita, supra, at 358 (specifying as an essential condition that the "competitive [non-cooperative] choice always yields a higher outcome than the cooperative choice"). However, each shareholder faces essentially the same dilemma, in that the noncooperating payoff is always greater than or equal to the cooperating payoff. Tendering is also the mini-max strategy in that it maximizes the smallest amount the shareholder will receive. See note 41 supra.

[119] This is referred to as an any-and-all offer, in which the offeror is obligated to purchase whatever shares are tendered.

[120] Under the Williams Act, if the offeror raises the price, it must pay the higher price to all shareholders who have already tendered at the lower price. 15 U.S.C. § 78n(d)(7) (1982). If tender offers were completely unregulated, the offeror would not have to pay the increased price. With respect to the example in the text, the shareholder who tendered to the $70 offer in an unregulated environment might therefore forgo any chance of receiving more per share.

[121] The free rider problem and prisoner's dilemma really are different ways of looking at the same problem. See, e.g., Bonacich, Shure, Kahan & Meeker, Cooperation and Group Size in

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however, is really adequate to describe the tender offer problem. The nub of the problem, which is not explicitly considered in traditional prisoner's dilemma analysis, is that there is a third strategic player in this game: the bidder.[132] In the specific situation of the noncompetitive tender offer, the bidder has monopoly power (assuming that only it can offer the synergistic gains) and all of the target's shareholders collectively, but not individually, have monopoly power. Since the individual decisionmaker in a tender offer has no monopoly over the supply of shares, one would expect the price to be less than in a negotiated bargain with an agent representing all shareholders.

Thus, if one wishes to analyze noncompetitive tender offers on the basis of game theory, the appropriate game is a veto game, not a prisoner's dilemma. In a veto game, the participation of one player (the veto player) is necessary to produce the gains, but only some of the other players (the nonveto players) need to reach an agreement with the veto player, and no single one of those other players is necessary. In the traditional example of a veto game, one player has a right shoe and numerous other players have a left shoe. A pair of shoes is worth $100, but single shoes are worth nothing.[123] Studies have shown that in such situations the player with the right shoe (the veto player) will pay only a small portion of the $100 to obtain a left shoe (and thus $100) from one of the other players.[124]

Although the modeling of such games is complex,[125] particularly where more than one nonveto player participates,[126] both theoretical and empirical evidence indicate that most if not all of the gain from the transaction will be allocated to the veto player.[127] The "payoff" to the veto player increases as the size of the group expands and the amount of communication decreases.[128] The target shareholders can increase their share if they are able to communicate effectively, but the bulk of the gains will still be allocated to the monolithic acquirer.[129] It is thus important in this context to distinguish between communication, which in some cases is like disclosure, and coordination, which enables the nonveto players to make readily enforceable commitments.[130]

In an acquisition where the synergistic gains are unique to the ac-

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the N-Person Prisoners' Dilemma, 20 J. Conflict Resolution 687, 688 (1976); Komorita, Sweeney & Kravitz, Cooperative Choice in the *N*-Person Dilemma Situation, 38 J. Personality & Soc. Psychology 504, 504 (1980) (identifying as *n*-person prisoner dilemma situations problems of overpopulation, ecology, environmental pollution, and the decision to join a union). Both situations distort choices and lead to noncooperative behavior which in the end fails to maximize either individual or social welfare.

That social as well as individual welfare is implicated may not be immediately obvious. It may be argued that this particular free rider problem or prisoner's dilemma affects only the distribution of gains and will not prevent a value-creating transfer. Regardless of whether the shareholders behave cooperatively, the ultimate outcome is the acquisition of the firm. The only issue is the distribution of the gain arising from that acquisition. The "game" is a constant-sum game, in which the acquirer and the target's shareholders choose strategies to maximize their share of the gain, but the choice of any one strategy does not affect the total amount of the gain, which is the overall social gain. Not all acquisitions, however, are constant-sum games. Rather, the gain may depend on the method of acquisition. If tender offers are more costly than mergers, but result in allocating more of the gains to acquirers, then the acquirer will choose the tender offer strategy even through it produces a smaller social gain. Suppose, for example, the gross total gain produced by an acquisition is $100, the merger transaction costs are $10, and the tender offer transaction costs are $30. Following the empirical data, see text accompanying note 75 supra, assume the gains in the merger will go entirely to the target whereas in a tender offer they will be divided almost evenly. The acquirer, of course, will choose the tender offer, for a net social gain of $70 and a private gain of $35. If a merger were used to effect the acquisition, the net social gain would be $90 but the acquirer would share in none of that gain.

[132] It might be argued that there is a third player in the classic prisoner's dilemma, namely the prosecutor who offers each prisoner a plea bargain that carries a lighter sentence in return for a confession implicating his fellow prisoner. But the prosecutor is not a strategic player in the sense that she forms a coalition with another player; rather her terms are set and the two prisoners merely decide whether to cooperate with each other. The game might be recast as a three-person game in which, unlike in a veto game, see text accompanying notes 123-32 infra, the two prisoners decide whether to form a coalition with each other for their joint payoff or to cooperate with the prosecuting attorney. This formulation resembles an "apex game." See J. Kahan & A. Rapoport, Theories of Coalition Formation 33, 52 (1984). (Technically, however, an apex game requires four or more players.) It is of interest in the tender offer context because, in the case of inefficient management, a tender offer can be thought of as an apex game. Either the target shareholders can cooperate with the offeror, and thus enable it to "throw the bums out," or they can cooperate with other shareholders to oust management through a proxy fight. But since the group which hopes to replace old management usually leads the proxy fight, it is difficult to draw a real world distinction between proxy fights and hostile tender offers in this particular respect.

[123] See Murnighan & Roth, Effects of Group Size and Communication Availability on Coalition Bargaining in a Veto Game, 39 J. Personality & Soc. Psychology 92, 95 (1980) [hereinafter Murnighan & Roth, Effects of Group Size and Communication]; Murnighan & Roth, Large Group Bargaining in a Characteristic Function Game, 22 J. Conflict Resolution 299, 303-04 (1978) [hereinafter Murnighan & Roth, Large Group Bargaining].

[124] See, e.g., Murnighan & Roth, Effects of Group Size and Communication, supra note 123; Murnighan & Roth, Large Group Bargaining, supra note 123.

[125] There are actually a number of different models, including most prominently the "value," "weighted probability," and "pivotal power" models. For a brief discussion, see Murnighan & Roth, Effects of Group Size and Communication, supra note 123, at 94.

[126] For a complex empirical study of coalition formation in veto and nonveto games, see Michener, Fleishman & Vaske, A Test of the Bargaining Theory of Coalition Formation in Four-Person Groups, 34 J. Personality & Soc. Psychology 1114 (1976) (testing the fit of experimental data against three models of coalition formation and payoff division).

[127] See, e.g., Murnighan & Roth, Effects of Group Size and Communication, supra note 123, at 93, 97.

[128] See id. at 97.

[129] See, e.g., Murnighan & Roth, The Effects of Communication and Information Availability in an Experimental Study of a Three-Person Game, 23 Mgmt. Sci. 1336 (1977).

[130] See Harsanyi, supra note 108, at 451 (distinguishing between "vocal" games where the players can communicate and "tacit" games where they cannot, and between "cooperative" games in which "the players are free to make enforceable binding agreements as well as other binding commitments," such as irrevocable threats, and "noncooperative" games in which such commitments cannot be made).

quirer and the target, the acquirer (the veto player) is necessary to produce the premium, but only some of the target's shareholders need participate. In other words, where only the specific acquirer and target can combine to produce the gains, a tender offer replaces a bilateral monopoly bargaining situation[131] (in which, for reasons outlined above, the target is the more effective bargainer) with a veto game in which the acquirer has a monopoly and only some of the target shareholders are needed to produce the gain.

Suppose, for example, that Corporation *A* already holds 40% of Corporation *B*, that it needs 10% more to effect the acquisition, and that the gains from acquiring the next 10% will be $100. If the remaining 60% is held by six individuals in equal amounts, *A* needs the cooperation of only one in order to obtain a majority (defined for these purposes as 50%). If the six shareholders got together they would likely be able to bargain for at least $50 (half of the gains), and possibly more. But if *B*'s shareholders act individually, they will know that if they do not accept a small premium, *A* need only find another shareholder who will. This analysis is borne out by empirical studies and theoretical models that indicate *A* will probably get the remaining 10% for a premium of $15 or less, retaining at least $85 of the gain.[132] While noncompetitive tender offers are more complex than this simple example, all game theory analyses point to the acquirer receiving most of the gains in an unregulated tender offer.

3. *The Auction Mechanism*

The dynamics of a tender offer will differ if the market for the target is competitive—that is, if there are other potential bidders. In a competitive market, the tender offer might develop into an auction, with interested companies bidding against each other for control of the target. While a tender offer is not the prototypical auction situation of one seller and few or many buyers,[133] each shareholder can be expected to respond

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[131] As its name implies, a "'bilateral monopoly' refers to any situation involving a single seller and a single buyer who must either agree on specific terms of exchange between themselves or fail to exchange their goods at all." Bargaining: Formal Theories of Negotiation, supra note 92, at 131 n.1 (editor's introduction to Part II).

[132] One experimental study found that in seven-person veto games (including the veto player), the average veto player's payoff was 95.4 (out of 100) in the absence of communication and 78.8 when communication was allowed among the nonveto players. Murnighan & Roth, Effects of Group Size and Communication, supra note 123, at 97. One theoretical model (the "weighted probability model") predicts a payoff of 85.7. Id.

[133] For discussions of prototypical auctions, see Myerson, The Basic Theory of Optimal Auctions, in Auctions, Bidding, and Contracting: Uses and Theory 149 (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed. 1983); Riley & Samuelson, Optimal Auctions, 71 Am. Econ. Rev. 381 (1981).

as if he were auctioning his shares to the highest bidder. The question we will want to consider is how high such a winning bid must be.

Although auctions have an ancient and venerable history,[134] only relatively recently have they received serious attention from economists as a method of pricing and resource allocation. An auction achieves two goals the market achieves much less easily: the determination of value when the preferences of potential buyers for an object are unknown, and the determination of value when the value is uncertain, even if the value is the same for all investors.[135]

Auctions may take many forms.[136] They may be open (oral), in which case bidders know the bids being made by others, or they may be sealed, in which case the bidder must submit a bid without knowing the bids of others. Sealed bid auctions may be either first-price, in which case the winning bidder pays the price he bid, or second-price, in which case the winning bidder pays the price bid by the next highest bidder. Oral auctions may be either ascending (the so-called English auction, which is economically equivalent to a second-price sealed bid auction[137]) or descending (the so-called Dutch auction, which is economically equivalent to a first-price sealed bid auction[138]). Such auctions may be with reserve, meaning that the seller retains the right not to sell to the highest bidder unless the bid is over a specified price, which may or may not be publicly announced. In an auction without reserve, on the other hand, the seller is bound to sell the object to the highest bidder. Finally, an auction may be "double" in that bids are submitted by both sellers and buyers, as is the case with securities markets.[139] Of course, an auction may constitute only one stage in the process of selling an object. For example, an auction may be held to determine a minimum price that will set the floor for subsequent bargaining between the seller and the buyer.

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[134] See Shubik, Auctions, Bidding, and Markets: An Historical Sketch, in Auctions, Bidding, and Contracting: Uses and Theory 33 (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed. 1983).

[135] In other words, the distinction is one between "preference uncertainty" (e.g., bidding for a rare art work) and "quality uncertainty" (e.g., bidding for natural resource rights). Engelbrecht-Wiggans, An Introduction to the Theory of Bidding for a Single Object, in Auctions, Bidding, and Contracting: Uses and Theory 53, 57-59 (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed. 1983).

[136] The seminal analysis and description of auctions is Vickrey, Counterspeculation, Auctions, and Competitive Sealed Tenders, 16 J. Fin. 8 (1961). See also Engelbrecht-Wiggans, supra note 135, at 61-64. For a comprehensive review of current auction methodology and theory, see Engelbrecht-Wiggans, Auctions and Bidding Models: A Survey, 26 Mgmt. Sci. 119 (1980). See generally Auctions, Bidding, and Contracting: Uses and Theory (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed. 1983). Of course, there are numerous mechanisms available to a society for distributing its resources. For a general review of these mechanisms, see Shubik, On Different Methods for Allocating Resources, 23 Kyklos 332 (1970). It is noteworthy that our society generally leaves both the decision to sell and the method for determining the price up to the seller, not the buyer, although this presumption is of little significance in competitive markets.

[137] In an English auction, the bidder openly communicates his bid and the auctioneer requests additional higher bids. Thus, absent strategic behavior, a profit-maximizing bidder will bid only a small amount above the last bid, even if the value he attaches to the object is far above that bid. In a second-price sealed bid auction, the bidders do not know the bids submitted by others, and the object is awarded to the bidder submitting the highest bid, but at the price of the second-highest bid. Under these circumstances, the equilibrium bidding strategy is to bid the maximum amount one is willing to pay. While the English auction and the second-price sealed bid are economically equivalent, they may differ strategically if the value attached by the bidder is dependent on the amount others are willing to bid. In the open English auction, a bidder will learn the valuations of other bidders and may revise his own estimate of the object's value accordingly, whereas, in a second-price sealed bid auction, the bidder can only guess what bids his competitors will submit. See Engelbrecht-Wiggans, supra note 135, at 62.

Generally, each of these auction mechanisms can be used to achieve efficient results; goods move from lower valuing to higher valuing persons. But the mechanisms may differ in the revenue produced for the seller, or in other words, in the allocation of the gain from the transaction between the buyer and the seller. Unfortunately, it will often be difficult to predict which auction mechanism is the revenue-maximizing one.[140]

Under some circumstances, for example, a first-price sealed bid auction produces greater revenue than a second-price auction since the bidder has to pay the highest price. But this will not always be true; in any type of auction, it is doubtful that the bidder will pay the value he actually attaches to the object. In an open auction, only where several offerors place the same value on the target will the competitive aspects of the auction procedure result in the bidder paying the value he attaches to the object.[141] And even first-price auctions (whether sealed bid or oral Dutch auctions) do not always result in the bidder paying the amount he values the object. Since the winner in such auctions is more likely to end up paying too much for the good (after all, the other bidders all valued the good for less), the bidders may lower their bids in order to offset this "winner's curse." Thus, in many circumstances first-price and second-price auctions result in the same revenue to the seller.[142]

In this light, proposals for an "auctioneering" rule in the tender offer context aimed at facilitating competing bids[143] may be seen as problematic. An auction by competitive tender offer bids is equivalent to an English auction. Thus, the price a bidder will have to pay to be successful in a tender offer depends not at all on the value it places on the target, but rather on the value the other bidders place on the target. If the bidder values the target more highly than any other bidder, it will pay only a nominal amount above the second highest valuing bidder. Thus, for example, if the firm trades for $50, Corporation *A* values it at $100, and ten other corporations value it at no more than $65, then *A* will pay only $66 in a tender offer. For reasons explained above, that $66 will be sufficient to induce shareholders to tender. Since such an auction is without reserve, it does not theoretically matter whether it is conducted by the managers of the corporation, its shareholders, or effectively without any auctioneer. It is clear, though, that this type of auction is not necessarily, and probably not usually, the revenue-maximizing procedure for the sale of corporations.

Adopting the auction solution may be allowing the tail to wag the dog. Since the vast majority of tender offers are not competitive, there is usually no auction at all.[144] There are a number of possible reasons why this is so. Potential bidders may engage in oligopolistic behavior and complex signalling patterns. A high initial bid premium by the first offeror, or a large jump in the premium offered by subsequent offerors, may convince others that the bidder is willing to pay a premium that they could not pay, making entry into the auction pointless. Even if other potential bidders believe they are willing to pay the same amount as the first bidder, they may still have little incentive to enter the auction. The first bidder already has incurred its information costs. If new bidders must incur similar sunk costs, a competitive bidding war may result in which the winning bidder will not be able to recoup these costs.[145]

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[138] The term "Dutch auction" derives from the method traditionally used for the sale of flowers in the Netherlands. The auction is started at a high price, and at specified points in time the price is lowered by an increment. The first and only bid is the one that wins. A bidder will "stop the clock" when the price reaches the maximum value he is willing to pay. If the bidder is not risk-averse, however, he may be willing to engage in some strategic behavior and wait beyond that point in the hope of acquiring the object for less than his full value; his risk, of course, is that someone else will bid first and acquire the object for less than he was willing to pay for it. Similarly, in a first-price sealed bid auction, bidders submit sealed bids and the object is awarded to the person submitting the highest bid at the amount of that bid. As with the Dutch auction, a bidder may scale down his bid in the hope that the second highest bid will be a significant amount below the value he attaches to the object. This tendency is further enhanced by attempts to offset the so-called winner's curse, see text accompanying note 142 infra. For these reasons, it cannot be assumed that a first-price auction necessarily results in greater revenue than a second-price auction.

[139] See Smith & Williams, An Experimental Comparison of Alternative Rules for Competitive Market Exchange, in Auctions, Bidding, and Contracting: Uses and Theory (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed. 1983); cf. Milgrom, Private Information in an Auctionlike Securities Market, in Auctions, Bidding, and Contracting: Uses and Theory at 137 (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed. 1983) (developing a model based on the role of "market makers"). Sales of treasury bonds differ. Long-term treasury bonds are sold through the equivalent of second-price sealed bid auctions, and short- and medium-term issues are sold through first-price auctions. See Baker, Auctioning Coupon-bearing Securities: A Review of Treasury Experience, in Bidding and Auctioning for Procurement and Allocation 146 (Y. Amihud ed. 1976).

[140] The problem of determining either the revenue-maximizing or optimally efficient auction procedure is complex and controversial. It depends in part on such usually undeterminable factors as buyer risk aversion. See generally Milgrom & Weber, A Theory of Auctions and Competitive Bidding, 50 Econometrica 1089 (1982); Myerson, supra note 133; Riley & Samuelson, supra note 133; Vickrey, supra note 136.

[141] The revenue produced by such auctions may be increased by holding it with reserve and not announcing the reservation price.

[142] See Capen, Clapp & Campbell, Competitive Bidding in High Risk Situations, 23 J. Petroleum Tech. 641 (1971); Klein, Joint Ventures and Bidding for Offshore Oil, in Bidding and Auctioning for Procurement and Allocation 38, 38-40 (Y. Amihud ed. 1976). On the winner's curse generally, see Engelbrecht-Wiggans, supra note 135, at 84-93.

[143] See Bebchuk, supra note 21, at 1034-50; Gilson, supra note 6, at 868-75; see also Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension, 35 Stan. L. Rev. 23 (1982); Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L. Rev. 51 (1982). Professors Easterbrook and Fischel reject the auction solution primarily because they believe it would not allow potential first bidders to recoup their sunk costs and hence would discourage identification of inefficiently managed firms. Easterbrook & Fischel, Auctions, supra note 6.

Furthermore, advocates of an auctioneering rule for tender offers have not fully considered the effect of the fact that many potential bidders will be interested in a number of potential targets. These bidders face the possibility of sequential auctions[146] of companies they have an interest in, but the acquisition of one target may make the acquisition of others less desirable or even impossible due to budgetary constraints. Companies considering a range of acquisitions thus may decline to participate in auction tender offers. If, for example, a company knows that it values a potential acquisition target at $100, and the current bidder values it at $80, but has bid only $70, the potential bidder may decline to enter the auction. Once the first bidder has acquired the target, it will no longer be a competitive bidder, and therefore the potential bidder may be able to acquire a different but similar target for a smaller premium. This may explain in part why tender offers often occur in industry-specific

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[144] Precise empirical evidence on this point is difficult to come by. One indication that competitive tender offers are the exception rather than the rule comes from observing the sample size in the stock price studies, which shrink dramatically when attention is focused on competitive tenders. For example, the sample studied in Ruback, Assessing Competition in the Market for Corporate Acquisitions, 11 J. Fin. Econ. 141 (1983), was derived from two earlier studies but limited to competitive offers. Whereas the earlier studies had reported samples of 172 (Dodd & Ruback, supra note 35) and 258 (Bradley, supra note 72), Ruback's sample of competitive offers was limited to 48. Further evidence is provided in W.T. Grimm & Co., Mergerstat Review 1984, at 90, 90-96. The number of companies acquired by "white knights" from 1976 to 1984 is reported in this study as follows:

RESULTS OF CONTESTED TENDER OFFERS

YEAR	TOTAL TENDER OFFERS	OF WHICH CONTESTED	TARGET ACQUIRED BY		REMAINED INDEPENDENT
			ORIGINAL BIDDER	WHITE KNIGHT	
1976	70	18	4	8	6
1977	69	10	2	5	3
1978	90	27	13	6	8
1979	106	26	8	9	9
1980	53	12	3	6	3
1981	75	28	13	9	6
1982	68	29	17	2	10
1983	37	11	7	3	1
1984	79	18	10	2	6
TOTAL	647	179	77	50	52

("Contested" indicates opposition on the part of the target corporation's management; it does not necessarily indicate that there was more than one bidder. It seems likely, however, that virtually all competitive tender offers (those in which there was more than one bidder) were also contested.)

If we take into account Ruback's observation that a subsequent bidder is successful in about 75% of the takeovers, see note 149 infra, then this indicates there were about 67 competitive takeovers in the period 1976 to 1984. The figure of 179 total contested takeovers is probably understated for these purposes, since it would not include a takeover in which a first friendly bidder won out over a subsequent bidder. This data and the Ruback data are consistent with an estimate that one-fifth to one-third of bids contested by the target are competitive. If the number of competitive bids is compared to the total number of tender offers, then the figure appears to be about 10% over the time frame. While most of the uncontested tender offers are properly excluded for these purposes since the transaction probably more resembles a "done deal," at least some of the uncontested offers are cases in which the target agreed to be acquired without negotiating, but would have been happy to accept an offer from a subsequent higher bidder.

Austin and Mandula report somewhat different but consistent data. Of the 120 resolved tender offers they count in 1985, 77 or 64% were uncontested. Between 1978 and 1985, according to their figures, 520 of the 770 resolved tender offers, or 68%, were uncontested. Only 1981 saw a greater number of contested offers (61) than uncontested offers (46). Austin & Mandula, supra note 1, at 68. The definition of "contested" used in this series is not entirely clear. Compare Austin & Jackson, Tender Offer Update: 1984, Mergers & Acquisitions, Spring 1984, at 63, 63 (defining contested as bid in which the target engaged in some defensive tactic or there was another bidder) with Austin & Mandula, supra note 1, at 56 (reporting the same data for earlier years, but now classifying offers as contested "if there was some resistance at any point during the bidding process").

On the basis of this information, my best estimate is that at most only about 20% of the tender offers that are meaningfully open to second bidders result in an actual second bid.

[145] See notes 51, 106 supra. It is plausible, of course, that the reason auctions seldom develop is that the first bidder, recognizing the potential for an auction, bids high to discourage other bidders. Yet it seems unlikely, given the enormous sums involved and the fact that second bidders stand to gain little from increasing the cost to first bidders, that this strategy results in the first bidder actually paying the price that would be paid in a competitive auction. This casual observation is supported by the empirical finding that the returns to bidders in all tender offers are not zero, see text accompanying note 75 supra, whereas they do approach zero in tender offers in which there is a second bidder, see Ruback, supra note 144.

[146] The holding of sequential auctions raises complicated problems both for the seller, in terms of maximizing sale price, and the buyer, in terms of bidding strategy. See Weber, Multiple-Object Auctions, in Auctions, Bidding, and Contracting: Uses and Theory (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed. 1983). The text discusses strategic reasons why a potential bidder in a tender offer may refrain from entering an auction initiated by another firm. But consider also the problem faced by a target that is the subject of a tender offer by a firm which values it less than another potential bidder. The target would like to get at least the second-price bid that would result from a competitive auction between the two bidders, but if the potential high bidder does not enter the auction, the target will not even get that, and if there are other attractive acquisition opportunities, the potential high bidder will have little incentive to enter the competitive auction. Under these circumstances, the target will have to adopt strategies that provide additional incentives for the high bidder to make an offer. These may include information sharing and a lock-up.

waves, and why bidders who make a bid for one company in such an industry do not enter bidding wars for other companies.[147] Given these limitations on acquirer participation in auctions, it is unlikely that every tender offer will be competitive, even if there are a large number of potentially interested acquirers.

4. *Tender Offer or Merger?*

We may now attempt to answer the question of when an acquirer will prefer to effect an acquisition by tender offer rather than by merger. Four acquisition scenarios may be usefully distinguished: (1) the market for corporate control is competitive for acquirers, that is, there are a number of firms that could gain by the acquisition, and the supply of such acquisition opportunities is scarce; (2) there is no competition for the acquisition, that is, the acquirer as well as the target are unique in their ability to bring gains to the transaction; (3) the bidder is unique in its ability to bring synergistic gains to a number of targets; and (4) neither the bidder nor the target is a unique provider of the type of expected gains. I will consider the tactical choice an acquirer is likely to make where the alternatives are an unregulated[148] (but potentially competitive) tender offer and a negotiated merger.

In the first case, where numerous acquirers compete for a single target, the bidder may prefer acquisition by tender offer because that will probably enable it to pay only a small premium above market. It does risk there being another firm which also values the target at a premium above market. At most, however, the acquirer will have to pay a nominal amount above the second highest price bid, and it may not have to pay even second price if there are only a small number of potential bidders who realize that all value the target equally and that a bidding war will result in only a nominal net present value investment. In other words, bidders may remain on the sidelines because there is little to gain by entering the auction market. This possibility is enhanced if the first bidder (or a subsequent bidder) has purchased a number of shares in the open market prior to commencing the tender offer. The firm which has made the open market purchases should be able to win any bidding war since it can pay slightly more for the remaining shares than the value it attaches to those shares and still have the same overall cost as other bidders.[149] A similar deterrent to a bidding war will exist if other potential bidders know that the current high bidder values the target firm more highly than they do, even though the current bid price is less than the price they would be willing to pay.

This analysis suggests that, in cases where the target is unique and the bidder is not, the bidder will prefer to make the acquisition by tender offer if (1) it believes it values the target most highly, or (2) it believes that all potential acquirers value the target equally and that this belief will be recognized by other potential bidders, and it makes the first bid. A negotiated merger, on the other hand, would be likely to result in most of the gains going to the target. In fact, this scenario could be modeled as a veto game, in which the target is the veto player and the potential acquirers are the nonveto players. As discussed above,[150] most of the gain in such circumstances goes to the veto player.

In the second case, where both the bidder and the target are unique, the bidder will also prefer a tender offer, because target stockholders are not bargainers but price takers and hence may surrender to a tender offer as being the only game in town. If the bidder negotiates with the target, a bilateral monopoly situation arises in which gains will be split evenly at best, and for reasons elaborated above[151] the target probably will capture the bulk of the gains. The tender offer, on the other hand, resembles a veto game (monopoly only on one side) in which most of the gain will go to the bidder, who in this scenario is the veto player. For similar reasons, the bidder should also prefer a tender offer in the third case, where the bidder is unique and there are a number of targets whose acquisition could produce synergistic gains.

In the fourth situation, where there is a truly competitive market in that neither bidders nor targets are scarce, the tender offer will likely provide little advantage for acquirers. Because of the availability of other potential targets, the target shareholders cannot get any more than second highest price. Under these circumstances, the firms should be able to negotiate a merger. Interestingly, one would suspect that acquisitions to replace inefficient management fall into this category, since there are probably a number of firms with inefficient management and a number of

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[147] Thus, for example, while DuPont might have considered a number of oil companies attractive acquisition opportunities, once it acquired Conoco it probably lost interest in acquiring another oil company. Furthermore, by raising debt load and depleting management capabilities, the Conoco acquisition may similarly have made infeasible, at least for the time being, even acquisitions of nonoil firms, such as specialized chemical companies or small bioengineering firms, in which DuPont may have been interested.

[148] See note 110 supra.

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[149] This analysis is supported by the fact that, in the overwhelming majority of cases (75%), if a competing bid is made the first bidder is unsuccessful. Ruback, supra note 144, at 147. In other words, competing bids are made only when the second bidder believes that in a bidding contest it will in fact be willing to pay more. An alternative explanation of this statistic is that bids are on the average less risky to competing bidders than to first bidders. First bidders generally are hostile and therefore lack important information available only to target management, whereas many second or lateral competing offers come from "friendly" bidders with whom target management has shared confidential information.

[150] See text accompanying notes 127-32 supra.

[151] See text accompanying notes 104-08 supra.

firms with management that could utilize their assets more efficiently.[152]

One might expect, on the basis of the preceding analysis, that most acquirers would choose to make acquisitions by tender offer. This is not the case.[153] There are several explanations why more acquisitions are effected by negotiated merger. One explanation is that most acquisitions may fall into the fourth category. Another is that managers of acquirers are risk averse and thus prefer mergers, which are less risky than tender offers.

A third possible explanation is that, in the long run, the significance of the tender offer lies not in its use but in its availability. As discussed above,[154] one of the most important factors in bargaining is the strategic alternatives of the parties. Thus, the availability of a tender offer should have a substantial effect on the bargaining in a merger. Since an acquirer always has the option of launching a tender offer for a target with which it is engaged in merger negotiations, those negotiations will, to borrow a phrase, take place in the "shadow of the tender offer."[155] Thus, with adjustments for transaction costs and risk differences, one would expect the distribution in gains resulting from one strategy to approach the distribution from the other strategy. If we choose not to regulate tender offers, then we are deciding not only how the gains are to be distributed in tender offers (essentially entirely to the acquirer), but also influencing how the gains will be allocated in negotiated mergers.

The Williams Act provides a fourth explanation for the prevalence of mergers. My conclusion above that tender offerors would snare the bulk of the gains assumed a world of unregulated tender offers. Of course, since the Williams Act, the bulk of the gains has not been allocated to the bidder. Although the data are inconclusive, the Williams Act appears to have had the effect of raising premiums, and the gains now appear to go predominantly to target shareholders.[156] Thus, the Williams Act diminished the relative appeal of the tender offer.

Why is there a difference between the Williams Act tender offer and unregulated tender offers? The main change under the Williams Act is to increase the time during which an offer is pending. Increased time allows for three things: communication in the form of a more meaningful role played by target management, possible coordination of shareholders through management defensive tactics or exhortation, and development of an auction market. Under the short pre-Williams Act bid period, the bidder could in most cases effectively assume a monopoly position. Under the Williams Act, however, a bidder who is not a unique source of synergistic opportunities will either have to make a higher first bid or risk being caught in an auction market. And, as noted above,[157] empirical studies indicate that both communication and coordination decrease the take of the veto player in veto games.

Still, the post-Williams Act empirical data do suggest that tender offers result in more of the gain going to acquirers than is the case in mergers. While the Williams Act eliminated many of the advantages of tender offers, it certainly did not eliminate all of them. Thus, it is not only in the face of inefficient or disloyal target management that an acquirer will choose to launch a tender offer rather than to bargain. If the acquirer's managers are loyal profit maximizers on behalf of their shareholders, they will choose the tender offer procedure whenever that procedure seems likely to bring their company a greater distribution of the gains resulting from the transaction. As described above, this would seem to be the case whenever the gains are unique to the specific combination. In addition, management of the offering company is able not only to secure a greater share of the gains for its shareholders, but also to retain control over the combined enterprise. Thus, in many situations a tender offer, as opposed to a negotiated merger, will benefit both the acquirer's shareholders and its management.

III

THE IMPLICATIONS OF THE DISTRIBUTION OF GAINS IN CORPORATE ACQUISITIONS

The empirical evidence and theoretical considerations discussed above indicate that both mergers and tender offers create gains, but that they may result in a different distribution of gains between the acquiring and the acquired corporations. Does this difference matter? To answer this question, we need to know where these gains come from, what sources of gains predominate, and whether the production of these gains is affected by acquisition procedures.

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[152] Of course, if management not only is inefficient but also resists being displaced, the availability of other targets will be irrelevant and the acquirer may be forced to use a tender offer.

[153] According to data compiled by W.T. Grimm & Co., only approximately 497, or 28%, of the 1,786 acquisitions of publicly traded companies effected between 1976 and 1984 were accomplished by tender offer rather than by merger. Included among these 497 transactions are completely friendly uncontested tender offers, which in strategic terms are more akin to negotiated mergers. If one limits the tender offer category to completed hostile or contested tender offers, the percentage drops to less than 7%. See W.T. Grimm & Co., supra note 144, at 90-96.

[154] See text accompanying note 103 supra.

[155] Cf. Cooter, Marks & Mnookin, Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior, 11 J. Legal Stud. 225 (1982); Mnookin & Kornhauser, Bargaining in the Shadow of the Law: The Case of Divorce, 88 Yale L.J. 950 (1979).

[156] See text accompanying note 88 supra.

[157] See text accompanying notes 128-30 supra.

A. *The Sources of Acquisition Gains*

Commentators have identified several possible sources of gains, which I will divide into four general categories: (1) synergistic economies, (2) replacement of inefficient management, (3) financial economies, and (4) market power.[158] Irrespective of their source, gains must result from either an increase in, or a decrease in the riskiness of, a firm's cash flows (with the caveat that no gain can be realized by decreased riskiness which the shareholders could have achieved just as well by diversifying their portfolios).[159]

Synergistic economies, as used herein,[160] include operating efficiencies,[161] certain financial economies, and the combination of different types of managerial expertise. Typically, synergistic economies result from some kind of vertical integration, where, for example, marketing strength is combined with research and development strength.[162] Horizontal integration may also produce synergistic economies where expansion results in economies of scale. Synergistic gains may arise as well from the union of two management teams that have different and complementary skills. For example, the target's management may be skilled in research and development, whereas the bidder's management may be skilled in marketing and finance.[163] These management-related gains, however, are to be distinguished from the mere replacement of inefficient management. They derive from an efficiency-producing combination of the acquirer's and target's managements rather than from a replacement of the latter by the former.

In some cases synergistic economies result from financial efficiencies.[164] An example is the combination of a firm with a high cost of capital but otherwise profitable investment opportunities and a firm with a low cost of capital but without similar investment opportunities. The unification of companies achieves a new and more balanced cost of capital and feasible investment possibilities, without incurring search costs or the costs of revealing information to outside investors.

A second source of gain is the replacement of an inefficient target management. The substitution of corporate control leads to a reallocation of the target's resources. The previous inefficiency of the target's management may have resulted from its pursuit of goals inconsistent with shareholder interests or from a lack of information that the acquirer is aware of and ready to exploit. It should be realized that this type of gain, unlike the others, could be realized without a merger or combination of the two firms.[165] The target company might purchase better management, or an alternative management team might launch a proxy fight.[166]

In addition to synergistic gains that derive in part from the financial attributes of one of the combining firms, there may be purely financial economies which may not produce real efficiency gains. Such financial economies include the utilization of unused tax shields (or conversely the sheltering of unsheltered income),[167] the avoidance or decrease of bankruptcy costs,[168] advantageous changes in capital structure,[169] and the reduction of borrowing costs.[170] Certain combinations of firms, such as a multinational conglomerate merger, may also decrease risk in a way not easily achieved by a portfolio investor through diversification.[171]

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[158] The potential sources of acquisition gains briefly surveyed here are not controversial. See, e.g., Bebchuk, supra note 21, at 1030-34; Jensen & Ruback, supra note 75, at 23-24.

[159] See note 44 and accompanying text supra.

[160] See note 20 supra.

[161] Operating efficiencies comprise those gains resulting from a decrease in operating expenses or transaction costs. Combinations of firms reduce such expenses by, for example, eliminating excess personnel or facilities. Coffee, supra note 11, at 1166 n.44; see also Note, supra note 20, at 1245 n.53 (operating efficiencies in vertical combinations derive from greater "control over the supply of raw materials or distribution of the end product").

[162] Because its benefits are difficult to identify in advance, basic research is arguably best supported by highly diversified firms. See Nelson, The Simple Economics of Basic Scientific Research, 67 J. Pol. Econ. 297, 302-03 (1959). See generally M. Kamien & N. Schwartz, Market Structure and Innovation (1982).

[163] A variation on this theme is that the development of larger conglomerates makes possible the adoption of more efficient managerial structures. See A. Chandler, Strategy and Structure (1962); A. Chandler, The Visible Hand: The Managerial Revolution (1977); Williamson, The Modern Corporation: Origins, Evolution, Attributes, 19 J. Econ. Lit. 1537 (1981).

[164] Financial synergy produces a "steadier, less volatile earnings stream" because "the acquired firm's business cycle offsets downturns in the bidder's business cycle." Coffee, supra note 11, at 1166 n.44. Other potential financial synergies include centralized cash balances, the transfer of working-capital funds among divisions, and reinvestment of excess funds internally. Note, supra note 20, at 1245. Such financial synergies may represent the only synergistic gains available in combinations of conglomerates or of unrelated businesses, since such combinations rarely produce operating efficiencies. Mason & Goudzwaard, supra note 27, at 45-46.

[165] See Bradley, Desai & Kim, supra note 10, at 184.

[166] Professors Easterbrook and Fischel have argued, however, that management is generally unwilling to replace itself and that proxy contests are expensive and often ineffective. For these reasons, they believe that combinations of firms are necessary to replace inefficient managers, and that such combinations will be achieved only through the tender offer mechanism. See, e.g., Easterbrook & Fischel, Proper Role, supra note 6, at 1170-74.

[167] Mergers are arguably stimulated by tax laws that allow the use of tax credits (generally available from investments) and offsets (permissible after losses) against later taxable income in place of cash refunds. M. Smirlock, R. Beatty & S. Majd, Taxes and Mergers: A Survey (1986); Lintner, Expectations, Mergers and Equilibrium in Purely Competitive Securities Markets, 61 Am. Econ. Rev. (Papers & Proceedings) 101, 106-07 (1971).

[168] See Coffee, supra note 11, at 1166 n.44 (diversification leads to less volatile income streams, thereby reducing bankruptcy probability and costs); Levy & Sarnat, Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers, 25 J. Fin. 795, 801 (1970) (arguing that the "joint probability" of financial failure is reduced by a merger between firms with "other than perfectly correlated income streams"). For a discussion focusing on conglomerate mergers, see Higgins & Schall, Corporate Bankruptcy and Conglomerate Merger, 30 J. Fin. 93 (1975).

Financial economies are interrelated: a reduction in bankruptcy costs will increase the debt capacity of the new entity and also lower the firm's borrowing costs. In addition, as the size of a firm increases, borrowing costs decrease because of economies of scale in credit investigation, flotation of public stock issues, and investor information. Mergers may also enable large firms to refinance debt of smaller firms at a lower cost.

Finally, acquisition gains may arise from market power resulting from a horizontal acquisition, where, for example, two firms in the same industry and market segment merge. Here the source of gain is the potential for monopoly or oligopoly profits.[172] While a recent empirical study concluded that acquisition gains do not arise from market power,[173] the evidence for this conclusion was ambiguous.[174] A more re-

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[169] Controversy continues to exist over whether there is an optimal capital structure for a given firm or only an ideal overall market mix. At least in the absence of taxes, leverage is probably irrelevant to share value. But once debtholders and equity holders are segregated into different groups, it is possible for equity holders to increase the value of their investment by increasing leverage. Professor Coffee cites this as a possible diseconomy of takeovers, Coffee, supra note 11, at 1244-49, but he is incorrect in suggesting that the motivation is peculiar to the merger context. In fact, it exists in all firms regardless of the level of leverage, although obviously the payoff increases as that level rises. Bondholders can protect themselves by including clauses such as financial ratio covenants and restrictions on additional unsubordinated debt; but they do not always do so. An interesting question is why firms do not consistently exploit existing bondholders by engaging in risky ventures or increasing leverage. One answer is that the firm will have to roll over its debt at some point in the future, and engaging in such behavior will increase the cost of its debt. The firm might thus be placed at a competitive disadvantage in relation to firms which did not engage in such creditor exploitation. The scenario might differ in the case of a tender offer, however. Where a highly leveraged acquiring firm acquires a less leveraged target, the target bondholders suffer but the bondholders of the acquirer do not. On the other hand, where the acquirer substantially increases its own leverage in order to undertake the acquisition, both acquirer and target bondholders suffer, and nonacquisition investment opportunities present exactly the same opportunity for the target shareholders to redistribute value from bondholders to shareholders.

[170] See Lintner, supra note 167, at 106-07.

[171] Barriers to international capital flows and the underdevelopment of foreign capital markets limit diversification opportunities for portfolio investors. For a discussion of how investment in multinational corporations helps circumvent these barriers, see Agmon & Lessard, Investor Recognition of Corporate International Diversification, 32 J. Fin. 1049 (1977).

[172] See generally Ellert, Mergers, Antitrust Law Enforcement, and Stockholder Returns, 31 J. Fin. 715 (1976).

[173] Eckbo, Horizontal Mergers, Collusion, and Stockholder Wealth, 11 J. Fin. Econ. 241 (1983).

[174] The study was based on the hypothesis that if market power is a source of gain in mergers, stock prices of rival firms should also benefit from the increased industry prices promised by the merger. The study found that rival firms do indeed experience statistically significant increases in stock price after the merger is first publicly announced: the rivals of 65 challenged horizontal mergers on average achieved a return of 2.45%, more than three standard deviations from zero, between the period of 20 days prior to the announcement and 10 days following the announcement. Id. at 269. But the data also showed a slight rise in rivals' stock prices as a result of the filing of an antitrust challenge to the proposed merger. Id. The author concluded from this finding that acquisition gains do not stem from market power; if they did, he reasoned, rivals' stock prices would have decreased inasmuch as the antitrust complaint makes it less likely both that the proposed merger will be consummated and that any expected mergers by rivals will go through. Id. This conclusion is too hasty, however. The filing of an antitrust complaint, particularly by the government, not only casts a shadow on the success of the merger (thus putting downward pressure on rivals' stock prices) but also provides proof

alistic view, particularly with the liberalization of the Justice Department's antitrust policy,[175] is that some mergers are undertaken in the hopes of realizing gains from market power rather than from any efficiencies.[176]

Two important observations can be made about the four types of merger gains. First, only one of these sources, the acquisition of market power, regularly produces social inefficiencies and is contrary to established public policy. Another source of gains, financial economies, also may result in inefficiencies when acquisitions are undertaken in pursuit of purely private financial savings (for example, taxes). The remaining two sources of merger gains, synergistic economies and the replacement of inefficient management, produce real social benefits. Transactions which produce either of these types of gains should thus be encouraged.

Second, regulatory policies are likely to have a disparate impact on the creation of these diverse sources of gains. A policy aimed at encouraging the creation of one type of gains will not necessarily encourage, and indeed may discourage, the creation of the other types of gains. It thus becomes important to know the degree to which each source drives acquisition activity. If, for example, there were evidence that the primary source of gains in acquisitions by tender offer is the replacement of inefficient management, then the arguments of those who advocate an unregulated market in corporate control would be persuasive.

But there is no such evidence.[177] Instead, the best recent evidence

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that the merger, if successful, will in fact create market power (thus putting compensating upward pressure on rivals' stock prices). The fact that rivals' stocks do not decrease following a complaint thus cannot be taken as proof that no market power will be created.

[175] Cf. Fox, Mergers, Antitrust and Pursuit of Freedom—A Modest Proposal, N.Y.L.J., July 1, 1985, at 1, col. 3.

[176] See Halpern, supra note 23, at 314 (concluding after assessing the Eckbo study that "monopoly power arguments remain viable theories to explain acquisitions").

[177] Professors Easterbrook and Fischel rely on stock price studies showing abnormal negative returns of targets prior to takeovers to conclude that targets are managed inefficiently. Easterbrook & Fischel, Proper Role, supra note 6, at 1187-88. But "the stock price studies seemingly stand alone; their picture of target corporations as lackluster companies that underperform the market is not corroborated by either statistical or financial studies of the typical target corporation." Coffee, supra note 11, at 1208. Furthermore, the stock price studies do not bear the weight that Easterbrook and Fischel have placed on them. Acquirers also show negative returns in the years prior to mergers and tender offers, Malatesta, supra note 73, at 180, as do other companies in the same industry as the target firms, Langetieg, An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Merger, 6 J. Fin. Econ. 365, 379 (1978), suggesting that tender offer targets "are disproportionately within depressed industries in which external events" cause poor performance, Coffee, supra note 11, at 1210.

An alternative approach to the abnormal returns studies is to employ discriminant analysis, that is, to identify through statistical analysis those characteristics of firms which most consistently predict them as merger targets. The studies undertaken thus far can best be described as inconclusive on the issue whether targets are in poorer financial shape than shows that neither tender offers nor mergers are explained primarily by the hypothesis of inefficient management.[178] The only conclusion that may be safely drawn from the financial literature is that stock price studies cannot clearly identify the relative importance of the sources of acquisition gains. Consequently, we must consider what the effects of alternative schemes of takeover regulation might be on the creation of gains from the variety of possible sources.

B. The Effect of the Distribution of Gains on Their Creation[179]

Professors Easterbrook and Fischel have repeatedly argued that if we regulate[180] the market in such a way as to lower the premium paid

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nontargets. See, e.g., Simkowitz & Monroe, A Discriminant Analysis Function for Conglomerate Targets, S. J. Bus., Nov. 1971, at 1; Stevens, Financial Characteristics of Merged Firms: A Multivariate Analysis, 8 J. Fin. & Quantitative Analysis 149 (1973); Wansley, Roenfeldt & Cooley, Abnormal Returns from Merger Profiles, 18 J. Fin. & Quantitative Analysis 149 (1983).

[178] See generally Harris, Stewart & Carleton, Financial Characteristics of Acquired Firms, in Mergers and Acquisitions: Current Problems in Perspective 224 (M. Keenan & L. White ed. 1982). Managers themselves overwhelmingly (84%) identify excellent management as a major attraction of target firms, whereas only a small minority (9%) identify poor management as a major attraction and a large majority (69%) find poor management no attraction at all. Coffee, supra note 11, at 1212 n.198 (citing Touche Ross & Co., The Effect of Mergers, Acquisitions and Tender Offers on American Business: A Touche Ross Survey of Corporate Directors' Opinions (1981)); see also id. at 1210-11 ("[T]he takeover movement has successively focused in a series of waves on different industries. . . . Incompetence is not a cyclical characteristic, and thus, if inferior management fueled the takeover movement, one would expect a fairly constant rate of takeovers.").

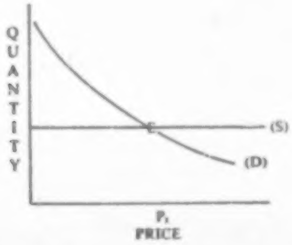
Additional evidence refuting the inefficient management hypothesis may be found in a recent study of joint ventures. McConnell & Nantell, supra note 76. Since the replacement of inefficient management can only be achieved by acquisition, whereas synergistic economies can be realized through other means such as joint ventures, one way to determine whether synergistic gains are significant is to examine whether announcements of joint ventures result in similar gains for the participating companies. The study found that joint ventures produce significant positive gains for the participating companies, but that these gains are much smaller in magnitude (on the order of 1%) than the gains associated with mergers and tender offers. Id. at 531-32. However, when the gains were related to the amount invested in the joint venture rather than to total company size (on the theory that joint ventures represent combinations of parts of the participating firms, not of the entire entities), the average "premium" or gain is 23%, which falls within the range for mergers. Id. at 533-34. The authors interpret this finding as evidence that the gains from mergers are derived largely from synergistic economies rather than from the replacement of inefficient management. Id. at 535.

[179] My concern here is solely with the distribution of gains between the acquirer and the target (or its shareholders); I will not address problems associated with the distribution of gains among the target's shareholders. On the latter issue, see generally Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297 (1974); Easterbrook & Fischel, Corporate Control, supra note 6, at 1194-1204.

[180] In general, Professors Easterbrook and Fischel purport to favor "deregulation" of tender offers. In fact, they appear to propose substituting one type of regulation for another. Specifically, they recommend decreasing the allocation of gains to targets by using freezeout mergers to prevent free rider opportunities, restricting the use of defensive tactics by target

(i.e., increase the amount allocated to the acquirer), there will be more tender offers, and, since tender offers are good, all shareholders will benefit.[181] But it does not follow from the assertion that tender offers are generally good that the more the better. The question is not whether there will be *more* tender offers, but whether there will be *enough*. In other words, one cannot assume that an increase in the demand for companies is beneficial unless one considers the relationship of that demand to the supply.

The "deadwood hypothesis,"[182] which posits that tender offers occur because of inefficient management, might be interpreted as assuming that the supply of targets is fixed, targets being defined as companies that are poorly managed. Certainly a change in the premium is not going to inspire a company to become poorly managed. On the other hand, because the gains to be realized vary from one acquisition to another, the demand will be affected by the price of the acquisition. Higher premiums will result in fewer tender offers. Thus, the supply and demand curve for target companies under the deadwood hypothesis may be sketched as follows,[183] with price defined as the amount of premium offered:



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management, and disallowing "fair share" provisions. See Easterbrook & Fischel, Corporate Control, supra note 6, at 710-11, 727-28; Easterbrook & Fischel, Proper Role, supra note 6.

[181] E.g., Easterbrook & Fischel, Proper Role, supra note 6, at 1174.

[182] The term deadwood hypothesis was introduced by Professor Lowenstein in Lowenstein, supra note 7, at 254, 272-76. Lowenstein himself does not subscribe to this thesis: "[T]ender offers are often a process of indiscriminate or random selection, rather than a process of pruning out the deadwood." Id. at 254.

[183] The shape of the demand curve itself is subject to considerable dispute. Easterbrook and Fischel have generally assumed that the demand curve, like typical demand curves, slopes downward whereas Gilson and Bebchuk have argued that, for various reasons, the demand for target companies is not particularly price sensitive. Coffee, supra note 11, at 1176.

It is somewhat like the market for rotten apples.[184] Rotten apples, like poorly managed companies, are a by-product of an otherwise well-functioning production process. No one intends to produce rotten apples or badly managed companies.[185] Once produced, they ought to be sold to the highest valuing user. If a hundred such publicly traded companies were produced each year, the only social need would be to clear them from the market. That would be accomplished at the theoretical equilibrium price (premium), P_E. The premium would be just low enough to provide an adequate return to those who invest in locating such companies. Any attempt to lower that price further, for example, by interfering with an auction market, will have no effect on supply.[186]

Of course, identifying the set of rules that would allow the market to reach the equilibrium price is a difficult task. But there is no reason to assume that the correct set of rules allocates all of the gain to either the bidder or target. Artificially allocating all of the gains to bidders despite the presence of a competitive acquisitions market will likely result in an overinvestment in searching for inefficiently managed companies.[187]

An important variant of the deadwood hypothesis, however, rejects the suggestion that the supply of poorly run target companies is fixed. Rather, the argument is that the larger the premium that must be paid in a takeover, the more managers can afford to shirk their duties without being threatened by a tender offer.[188] For example, if a company's shares under current management are worth $80 per share but would be worth $105 under efficient management, and if successful tender offers require a premium of 50% above market, no tender offer will occur, and management can sap another $10 of value from the company before it becomes a viable takeover target. Under this view, the supply of inefficiently managed companies rises with the price of a successful takeover, as follows:

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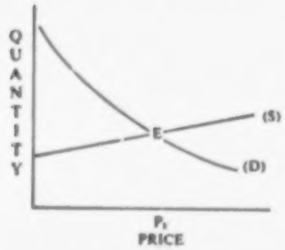
[184] I assume here that there is some market for rotten apples, such as feed for animals.

[185] One could argue that managers who are attempting to loot their companies, or to enjoy the perquisites of management while shirking their responsibilities, are in a sense intentionally creating such companies. For reasons outlined by Coffee, supra note 11, at 1200-01, it is unlikely that the market for corporate control can effectively police those who intentionally exploit their companies.

[186] This analysis is not significantly affected by transaction costs such as the cost of identifying potential targets if, as seems likely, such costs are a small part of the entire potential gain. Taking account of transaction costs will shift the demand curve to the left, thus lowering the equilibrium price and precluding only those transactions that produce gains too small for these additional costs.

[187] See Bebchuk, supra note 21, at 1046-48.

[188] See Easterbrook & Fischel, Proper Role, supra note 6, at 1168-74.



Unlike most goods, however, inefficiently managed companies are undesirable. In order to reduce this unwanted supply, Professors Easterbrook and Fischel advocate depressing the premium price by deregulating the tender offer market and tightly restricting the conduct of corporate managers in resisting tender offers.[189]

This argument, however, makes a crucial and unsubstantiated assumption, namely, that it either does not matter how the gains from tender offers are divided between bidders and targets, or, at least, that we need not encourage targets to create any gains. In this regard, the creation of gains should be distinguished from their identification. If the source of merger activity is assets that are undervalued because of market inefficiency or management incompetence, then target corporations are like oil in the ground. They need only to be identified; no incentive for their creation is necessary. Thus, if tender offers were used solely when the source of gains is inefficient management, a rule that allocated all the gains to the acquirer might make sense from the stockholders' ex ante viewpoint. Such a rule would provide the maximum incentive for management to be efficient and loyal.

But the additional sources of merger gains surveyed in the preceding section do not support this simple analysis. If tender offers serve as a means of realizing any of the types of economies that may result from a negotiated merger, then the suggestion that targets should be allotted little or none of the gains deriving from the combination necessarily assumes either (1) that there are no gains derived from mergers which should be encouraged, or (2) that all gains which are derivable from mergers are provided by the acquirer (that is, only the acquirer needs to be provided with an incentive to produce the gains). The first assumption suggests that all mergers except those designed to replace inefficient management are bad (a point of view advocated by virtually no one); the second is refuted by, among other things, the fact that in many mergers the designation of acquirer and target is arbitrary or, worse, depends solely on relative size.

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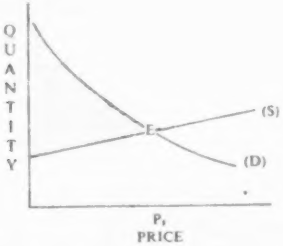
[189] See id. at 1194-1204; Easterbrook & Fischel, Auctions, supra note 6, at 15-17.

It thus seems beyond dispute that the market should provide incentives to create many of the efficiency gains, other than the replacement of inefficient management, that may arise in mergers. If, however, tender offers were completely unregulated and defensive tactics forbidden or rendered ineffectual, then we could expect virtually all of the gain to be allocated to acquirers. To the extent that the creation of those gains may be the result of conscious investment decisions by potential target corporations, the failure to distribute them to the target will discourage their creation.

An increase in the supply of targets in the market for corporate acquisitions, therefore, is not necessarily a bad thing. If acquisition gains result from more than poor management, we may want to offer incentives to create a supply of such gains. Thus, if the correct supply and demand curve is the second one sketched above, but the increase in supply which results from greater premiums reflects an increase in social welfare, regulatory policies that force the price to the zero premium level result in forgoing that social gain. Graphically, the area of the shaded triangle below represents the potential forgone gain in the value of the output of goods and services.



In other words, regulating the price by tampering with the distribution of gains through regulatory schemes might have important efficiency consequences. It will reduce the incentive of companies to pursue value-maximizing strategies that rely on transforming them into attractive acquisitions in a bargaining transaction. Companies which might have been converted into acquisition opportunities may instead embark upon courses of action that produce less value. Furthermore, enterprises whose primary value was expected to be realized through a nonequilibrium acquisition may not be undertaken at all; this ambition of starting a company, leading it through a period of growth, and converting it to an attractive acquisition candidate is by no means unheard of.[190] This casual observation is supported by the suggestion that the optimal firm size for invention, as opposed to other product cycle functions, is small.[191]

Consider, for example, a small research and development firm that has two alternative development strategies. One strategy is to develop products and market them on its own, in which case shareholder value will be $75. The alternative strategy is to put all the firm's resources into development, thus enabling the firm to become a particularly attractive acquisition for another company to which the firm, because of its special fit, would be worth $100 per share. If the firm adopts the second strategy and is not acquired, however, its shares will be worth only $50. If tender offer rules allow the acquisition at a small premium above market, the potential target risks being worth only $50 to its stockholders if it chooses the second development alternative. The managers will therefore choose the first strategy, since the $75 represents a better value. On the other hand, if the rules required bargaining rather than tender offers, the managers may adopt the second strategy, believing that they can obtain more of the gain for the target in a negotiated merger.

It is important to note in this example that there is more at stake than the distribution of gain between the shareholders of two firms. Rather, the small firm's decision whether or not to become an acquisition candidate affects the efficient (optimal) use of resources and thus social welfare. Furthermore, the potential inefficiencies are not erased by a general assumption of capital market efficiency. If legal rules enable acquirers to realize synergies in a way which gives little or no part of the gain to the target, then no amount of market efficiency will reward targets for investment in what might be termed synergistic strategies.

Of course, companies which want to pursue such strategies could simply avoid going public, or go private if they are already public. But this strategy in turn may result in an underinvestment in such companies if public equity capital is the most readily available investment source. However one decides to regulate tender offers, the effect on businesses' choices between public and private sources of capital should be considered.

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[190] One example of this phenomenon may be the semiconductor industry, which was virtually entirely acquired by larger firms in the 1970's. See Coffee, supra note 11, at 1210-11.

[191] See Gilman & Siczek, Optimization of Inventivity, Research Management, July-Aug. 1985, at 29.

Even assuming that the primary source of tender offer gains is the replacement of inefficient management, it does not necessarily follow that target shareholders, or even current management, should not share in the gains that will result from the acquisition. That current management has created an advantageous opportunity for better management will not always be to its discredit. It may very well be that management sought to create opportunities which it could not exploit as well as others. To say that management is "inefficient" may mean no more than that it has managed an enterprise very well through various stages of development to the point where management with different talents, or even simply better management which was not previously worth the additional cost, will maximize shareholder value. True, management may be unwilling to accept the need for its replacement. Rather than agreeing to a merger, it may try to hire managers away from other firms or to acquire another firm which already has the necessary managerial talents.[192] But surely this is the kind of management "inefficiency" which we would expect and desire young firms to incur at some point. Synergy gains as well as gains in improving management are likely to be realized when such firms are acquired. Depriving the target shareholders of any premium under these circumstances will eliminate any incentive for potential target management to create opportunities for the realization of these gains, even assuming maximum loyalty to shareholders.

The uncertainty and variety of the sources of acquisition gains have implications for "fairness" arguments as well as efficiency arguments. Part of the appeal of the Easterbrook and Fischel approach is that a solution which gives the gains of a tender offer to the "good" or "superior"

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[192] At least one writer has asserted that the market for corporate managers is more important than the market for corporate control. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980). One of the important flaws in the Easterbrook and Fischel analysis is their view of management as monolithic and homogeneous. In reality, it is conceivable that the sole strength of the topmost management of conglomerate firms is in selecting, inspiring, and disciplining second-tier managers who function autonomously.

The view that upper level conglomerate managers function primarily as financial managers comports with a synergy theory derived from an evolutionary view of firm development. In the early stages of firm development, product management will be the most important function. As a firm grows larger and its operations more complex, however, financial diseconomies will become important. The firm may compete in the market for managerial talent or may become the target of a company which already has available such talent. It does not, however, follow from such value-creating combinations that the target management has failed in its duties. In this sense, the market for corporate control, both for acquirers and targets, may in some instances function as a part of the market for managerial talent in which either the talent may acquire the firm or the firm may acquire the talent. Cf. Coffee, supra note 11, at 1237 ("the cost of attaining perfect competition in the market for corporate control is substantial impairment of the efficiency of the executive labor market").

management (actually the bidder's shareholders) and denies them to the "bad" or "inferior" management (actually the target's shareholders who have failed to evict their inept management) seems just and proper. But the concept of justice in the world of corporate control is not so simple. While the abstract principle that "those who produce a gain should be allowed to keep it"[193] may be satisfactory so far as it goes, it suffers from the fatal flaw that we often cannot tell who really "produces" the gain. Merely because a transaction creates gain does not mean that it is the transferee (the buyer) who has produced or created the gain. In fact, in many situations we allow the seller to reap any increase in the value of assets he owns.[194] Rules that attempt to distribute those gains wholly to buyers may destroy the incentives of sellers to produce them. This is true not only for consumers but for investors in productive property as well. It is not the sharing of gains which deters value creating transactions, but rather the not sharing of gains. Assuming that those transactions can to some extent be predicted and anticipated, it is plain that both buyers and sellers must gain from the transactions in order for them to occur.

I agree with Easterbrook and Fischel that if unequal sharing is necessary to produce such gains, then the law ought to allow unequal sharing.[195] What is odd about Easterbrook and Fischel is that they implicitly adopt what they purport to reject. To advocate nonregulation of tender offers and the prohibition of defensive tactics is to mandate a rule on the sharing of gains: all the gains go to the acquirer. Such a rule could be justified only by persuasive evidence that (1) the rule is necessary to create the gains in some transactions, and (2) it does not lead to the failure to produce gains in other transactions. There is not sufficient empirical or theoretical support for either of these propositions.[196]

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[193] Easterbrook & Fischel, Corporate Control, supra note 6, at 698.

[194] See note 136 supra.

[195] See Easterbrook & Fischel, Corporate Control, supra note 6, at 708-10.

[196] Professors Easterbrook and Fischel have further argued that, apart from the issue of inefficient management, investors do not care how gains are distributed between acquirers and targets because investors hold diversified portfolios and thus will be on the winning side of some transactions and the losing side of others. Id. at 712-14. This argument contains a number of significant flaws, even assuming that the distribution of gains arising from tender offers does not affect their creation. First, because bidders can acquire numerous targets, but a target can only be acquired once, there may be a diminishing likelihood over time that bidders and targets are equally represented in an investor's portfolio. Completely allocating gains to either targets or bidders thus increases the riskiness of the portfolio with respect to the realization of those gains. Since investors will optimally hold a portfolio of only about 20 stocks, see E. Fama, Foundations of Finance 253-54 (1976), they may prefer that the gains be divided roughly equally in order to reduce risk without incurring the transaction costs of increased diversification.

Second, Easterbrook and Fischel overlook certain asymmetries that suggest that public security holders would prefer tender offer gains to be allocated to targets. Because tender offers by definition can be made only for publicly held companies, the smaller the amount of

To equate "synergy gains" with the "effort and resources that the controlling firm put into accomplishing the merger"[197] is to assume one's conclusion. In fact, the gains may arise regardless of which firm is the acquirer and which is the acquired, so long as the combination occurs. From this perspective, the so-called Pac-Man defense, in which a target launches a counter tender offer for the bidder, makes sense.[198] Both managements recognize that the combination is advantageous, but they disagree as to which management should rule the combined enterprise.[199]

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gain allowed to the target, the greater amount will potentially go to privately held or foreign companies which cannot form part of an investor's portfolio. See Quarterly Profile, Mergers & Acquisitions, Spring 1985, at 75, 75 (reporting that, in the first quarter of 1985 alone, foreign companies acquired 56 United States companies for a total value of $6.8 billion, which represents approximately 23% of the total merger and acquisition activity for that period); The Rising Tide of Mergers, N.Y. Times, June 28, 1985, at D1, col. 3 (included in the 25 largest mergers and acquisitions initiated during the first half of 1985 were four private acquiring companies with an aggregate value of $7.8 billion). Furthermore, most countries place greater restrictions on acquisitions by foreign entities than does the United States. Thus, one cannot assume that gains allocated to foreign acquirers will be offset by gains to American companies from acquisitions effected through foreign securities markets. This imbalance may be exacerbated by special advantages that foreign companies have in competing for American acquisitions. Thus, rules that allow bidders to capture all the gains may result in exporting those gains without compensating the American economy for at least part of their production.

Third, even if the allocation of gains is irrelevant to their creation, the allocation may be important with respect to whether the gain-producing transaction occurs at all. Easterbrook and Fischel have argued that the gain from replacing inefficient management should be allocated to bidders, thus providing the maximum incentive for firms to invest in searching out inefficiently managed firms. Easterbrook & Fischel, Corporate Control, supra note 6, at 705. But it is not clear that this policing role is played solely, or even primarily, by acquirers. Rather, an important role may be played by those who have less capital and acquire a small but significant percentage of a company in order to trigger a tender offer. To the extent such investors select a portfolio, it is a portfolio of companies they believe are attractive takeover targets. If an acquirer could launch a low premium tender offer at any time, an investor who had purchased shares in the belief the company was badly managed and could be sold at a higher price to an acquirer would lose the chance to earn an adequate return on his search and investment costs. Indeed, investment in such information would become more risky even for the actual acquirers, since they could not be sure that by buying a small amount of stock they would at least be compensated for their search costs. And since well managed large companies do not have as a primary aspect of their business the searching out of inefficiently managed companies, greatest efficiency likely is achieved by having specialized firms undertake these tasks, at least with respect to some kinds of acquisitions. Thus, it is not at all clear that awarding all the gains to bidders, even in takeovers of inefficiently managed firms, will maximize the amount of such takeover activity.

[197] Easterbrook & Fischel, Corporate Control, supra note 6, at 728. It is similarly erroneous to equate the premium over market paid for a firm's shares in a tender offer with a "control premium," as is done in Greene & Junewicz, A Reappraisal of Current Regulation of Mergers and Acquisitions, 132 U. Pa. L. Rev. 647, 658 (1984).

[198] See generally DeMott, Pac-Man Tender Offers, 1983 Duke L.J. 116. In other words, given the model of the takeover market as "a market in which alternative managerial teams compete for the rights to manage corporate resources," Jensen & Ruback, supra note 75, at 6, incumbent management ought to be permitted to compete in that market.

[199] Particular difficulties arise if one assumes that many or most takeovers are driven primarily by synergistic gains. If the target management agrees that a combination is value creat-

The allocation of the roles of bidder and target does not necessarily tell us which company has the better management. And since under current regulation acquirers tend to be larger firms, a rule that allocates gains to acquirers favors, without reason, large firms over small firms.

The possibility that a combination of two firms is desirable regardless of which firm's management assumes control over the combined entity suggests an additional problem with the tender offer mechanism. When two firms combine, three managerial options are presented. The current management of firm *A* could manage the combined entity, the current management of firm *B* could manage the combined entity, or the managements could be combined. A successful tender offer involves a determinate solution to this issue (in favor of the management of the firm making the tender offer), whereas a negotiated merger does not.

Given the interest of managers in retaining their jobs, a negotiated merger is more likely to produce a combined entity in which the management of the two firms is also combined. One might suspect that in many cases a successful integration of management would be the value maximizing option, but that the managers of either firm would maximize their own welfare by achieving sole control. In such cases, the interests of management and shareholders of the acquiring firm will diverge. The decision to launch a tender offer can be understood as a way of achieving a desirable combination without the management cost of sharing the management of the larger entity. Thus, the firm which launches a tender offer will be the firm whose management is less loyal to its shareholders, and the acquisition, while creating gains, will be less efficient than a merger. Under these circumstances, increases in efficiency would be realized by encouraging merger negotiations.

IV

CONCLUSION: RECONSIDERING THE RULES OF THE GAME

> "I don't think they play at all fairly," Alice began, in rather a complaining tone, "and they all quarrel so dreadfully one can't hear oneself speak—and they don't seem to have any rules in particular: at least, if there are, nobody attends to them—and you've no idea how confusing it all is . . . ."[200]

A little knowledge can be a dangerous thing. The insight that

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ing, how should it respond to a tender offer if it believes it is the better management? A tender offer for the other firm is not, from the stockholders' viewpoint, a competing offer, and a self-tender or leveraged buyout does not serve the goal of combining the firms. But should the right to manage the combined entity necessarily belong to the firm which makes an offer first?

[200] L. Carroll, Alice's Adventures in Wonderland 64 (Bantam Classic ed. 1981).

tender offers can serve the important function of disciplining management in the modern corporation is undeniably a valuable one. In many instances, the tender offer has served that function admirably. But the financial world is not so simple as economists assume it and law professors imagine it. We should be wary of simple prescriptions for complex phenomena.

This Article has sought to deepen our understanding of the complexity of corporate acquisitions by demonstrating that the distribution of gains between acquirers and targets in tender offers may have important efficiency consequences. The variety of the sources of acquisition gains, and our lack of knowledge about the necessary incentives for their creation, should make us uneasy about any prescription to reduce tender offer premiums to a point nominally above market value. At least in some cases, efficiency and ex ante value will be maximized by allocating much if not all of the gain to the target corporation. The tender offer, as the only corporate control transaction that uses the securities market rather than corporate bargaining mechanisms to determine price,[201] has

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[201] The contrast is worth exploring. General corporate law attaches great importance to the sale of the corporate business. State laws generally require shareholder approval of such sales, sometimes by a supermajority. See, e.g., Manne, supra note 22, at 117. If none of the gains from such transactions were to be allocated to the shareholders, there would be little reason to structure transactions in that form; all corporate control transactions for publicly held corporations could be effected through the market in shares. (Indeed, I have sometimes wondered whether Professors Easterbrook and Fischel might favor a system under which any bidder who offered to buy a firm at more than its current share price, and placed the requisite funds in escrow, would be automatically entitled to complete the acquisition at the offered price. Such a mechanism would certainly diminish transaction costs and eradicate defensive tactics.)

The reason for the special treatment of corporate sales is found largely in the historical development of the corporation. See Carney, Fundamental Corporate Changes, Minority Shareholders, and Business Purposes, 1980 Am. B. Found. Research J. 69. But there is also a sound economic basis for singling out these transactions. The ordinary commercial transactions which make up a corporation's daily existence generally take place in the context of an active and liquid market. The market forces of supply and demand determine the price at which inputs can be bought and outputs can be sold. Little would be gained from a shareholder policing mechanism over such transactions, because the market itself polices them. Similarly, when the corporation chooses to issue additional securities to a public market, the pricing of those securities is subject to the impersonal pricing mechanisms of the securities market. These ordinary business transactions usually involve many sellers and many buyers. Absent strong monopoly or monopsony power, the firm cannot control the price at which the transaction will take place and therefore is unlikely to make serious errors in these pricing decisions.

When an entire company comes up for sale, however, the market generally consists of only one seller (at least at any particular point in time) and a few buyers. Because of differing potential synergies, the value of the company may vary from one buyer to another. The managers of both the selling company and the potential buying companies are likely to be uncertain as to the seller's value. Of course, one guide to the seller's value is the aggregate value of its publicly traded stock. As suggested above, however, see text accompanying notes 62-71 supra, because the market prices such stock without necessarily taking into account potential synergies, it really makes no more sense to determine the value of a company as a potential

the consequence of lowering the price paid to target shareholders in some acquisitions. In this light, the argument that management should have recourse to a vast arsenal of defensive tactics in the face of a tender offer[202] may be interpreted as an argument that it is to the shareholders' advantage to use the corporate bargaining mechanisms, rather than the securities markets, for corporate sale transactions.

The bargaining justification for defensive tactics offered here is more narrow, however. The justification for management defensive tactics is not merely that bargaining will result in a greater allocation of gains to the target, but also that these gains are necessary to compensate the target for its investment in potential synergies. Thus, while virtually all defensive tactics could be defended on the general bargaining or shareholder coordination rationale, the approach advocated here discriminates among the widely varied antitakeover weapons which current law and practice provide target corporations.

These weapons may be grouped into four basic categories. First, there are structural measures that prevent anyone from acquiring control from public shareholders. These measures include retention of a majority interest by insiders[203] and use of dual class common stock.[204] Second, a corporation may in advance of any specific takeover threat adopt charter amendments or bylaws that make a takeover more expensive or risky and thereby encourage the potential acquirer to seek the agreement of the board of directors. Third, when faced with a specific takeover threat, management may seek to adopt such measures. Fourth, management

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acquisition by aggregating the market value of its shares than it does to do so by aggregating the market value of its assets. Thus, market forces provide insufficient guidance in the pricing of these sales, necessitating a corporate bargaining mechanism, supported by a public shareholder vote, to protect against error. Absent the scenario where both numerous bidders and numerous targets could provide the anticipated acquisition gains (in which case a bidder is unlikely to use a tender offer anyway, see text accompanying note 152 supra), the tender offer mechanism creates the same risk of serious pricing error. Here too a corporate mechanism whereby shareholders can supervise a bargaining process may be necessary to compensate for the deficiencies of the market.

[202] See Lipton, Takeover Bids, supra note 7; Oesterle, supra note 14.

[203] The number of such companies in which the minority is widely held is small, and tends to include smaller firms, such as World Airways and Playboy Enterprises.

[204] The number and importance of such companies have been limited by the listing requirements of the New York Stock Exchange, which has prohibited them, and the American Stock Exchange, which has discouraged them. See generally Seligman, Stock Exchange Rules Affecting Takeovers and Control Transactions, 55 Geo. Wash. L. Rev. (forthcoming 1986). This group nonetheless includes some very important corporations, such as Ford Motor Company and Wang Laboratories. Id. at n.78. While the desirability of permitting dual class common stock for publicly held corporations is subject to serious debate, it seems silly to permit such arrangements while at the same time advocating rigid restraints on defensive tactics of single class common companies. Interestingly, empirical research on the value of "control" in the context of dual class common stock has been ambiguous. See Lease, McConnell & Mikkelson, The Market Value of Control in Publicly-Traded Corporations, 11 J. Fin. Econ. 439 (1983).

may use nonstructural defenses, such as litigation, crown jewel options, and stock lock-ups, to fend off an offeror.[205]

Investment in potential synergies may require that the firm be able to obtain a greater share of such synergistic gains than would result from its acquisition by tender offer. This justification for defensive tactics loses its force, however, unless the ability of management to obtain a greater share of the synergistic gains is known in advance. If the distributional outcome is highly uncertain, then investments in synergies will be unnecessarily risky. Thus, the third and fourth types of defensive strategies identified above, which are adopted only *after* a takeover threat materializes, are difficult to justify, except insofar as they are necessary given the shortcomings of the first two types. If management believes that its right to say no to an unsolicited offer is in the shareholders' best interests, it ought to retain that right at the time the corporation's shares are distributed to the public, or secure that power from the shareholders thereafter.[206] The share prices of those corporations that adopt charters enabling management to bargain more effectively, or even to prevent takeovers, will adjust accordingly. Theoretically, the price of the shares of those corporations whose "antitakeover" charter amendments are viewed as enabling them to secure a greater part of a synergistic gain will rise, and the price of the shares of corporations whose charter amendments are not perceived to have such a justification will fall.[207] Thus, the first and second types of defensive tactics identified above, structural defenses adopted prior to a specific takeover threat, should generally be permissible.

Not all preoffer structural tactics can be justified, however. The more complicated and less efficient tactics ought to be unnecessary. One of the problems in this area has been the inability of management to formulate structural changes that effectively coerce bargaining without entailing other undesired costs. The result has been a hodgepodge of the most Byzantine corporate instruments.[208] Granting corporations true

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[205] For a full panoply of defensive tactics, see Harrington, supra note 14, at 984-87.

[206] An analogous approach is found in charter provisions that take a liberal approach to self-dealing by managers or directors.

[207] Despite the continued theoretical attacks on such amendments by those who otherwise draw on stock price data in support of their theses, the wealth effects of antitakeover amendments (as measured by stock price data) are decidedly ambiguous. Compare DeAngelo & Rice, Antitakeover Charter Amendments and Stockholder Wealth, 11 J. Fin. Econ. 329, 356 (1983) (concluding that the evidence, although not statistically significant, provides "weak preliminary support" for the managerial entrenchment hypothesis) with Linn & McConnell, An Empirical Investigation of the Impact of 'Antitakeover' Amendments on Common Stock Prices, 11 J. Fin. Econ. 361, 397 (1983) (concluding that "[a]lthough the results are not unambiguous, the overall impression yielded by the analysis is that the introduction and adoption of antitakeover amendments is associated with an increase in common stock prices").

[208] A good example is the poison pill flip-over, which is a provision in a right or preferred

flexibility in adopting structural defenses should eliminate the need for such blunt instruments.

In short, there seems little basis for regulating tender offers in a way fundamentally different from mergers. The optimal type of regulation is the one generally applied to corporate structural changes: enabling statutes that set default or minimal standards, allowing for variation in the corporate charter. Such a regulatory approach would seem most likely to take into account our skepticism that the rule chosen will be best both as a general proposition and for every specific case. Fixed rules create inefficiencies, both to the extent they may be inefficient as applied and to the extent they invite inefficient means to circumvent them. Flexible rules subject to contractual modification allow individuals to make errors but preserve the basic integrity of a decentralized market system based on investor and consumer preferences.[209] Furthermore, regulatory systems, whether by legislation or administrative action, respond more sluggishly to changes in circumstances than do contract-based approaches. And if the last couple of decades are any indication, few areas are more dynamic than corporate finance.

This is not to say that managements and original shareholders will be free to adopt whatever rules they want. The capital markets will implicitly value the consequences of the rules selected. But as long as there is reason to believe that the market is capable of making those evaluations, and reasonable prerequisites for efficient market function and ra-

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stock that grants to the holder of the acquired corporation's stock a right to acquire the common stock of the acquirer corporation at a bargain purchase price (typically one-half the market value), thus diluting the value of the acquirer's common stock. See, e.g., Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred, 97 Harv. L. Rev. 1964 (1984). The right of a board of directors to issue rights with a flip-over provision has been upheld in principle by the Delaware Supreme Court, although the court did indicate that actions taken by the board at the time a tender offer materializes would be subject to scrutiny under the business judgment rule. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985).

[209] This flexible approach is embodied not only in corporate enabling statutes but also in commercial law. Although commercial activity had traditionally been regarded as more suitably governed by fixed, formal rules, the drafters of the Uniform Commercial Code, especially the provisions on sales (Article 2), favored flexible standards subject to modification by the contracting parties. Kennedy, Form and Substance in Private Law Adjudication, 89 Harv. L. Rev. 1685, 1704-05 (1976). Thus, most Article 2 provisions are default rules that apply only if the parties have not "otherwise agreed." See U.C.C. art. 2 (1978); J. White & R. Summers, Handbook of the Law Under the Uniform Commerical Code 7 (2d ed. 1980). The U.C.C.'s general jurisprudential preference for nonmandatory and flexible rules has not engendered substantial dissent. An approach that allows business actors of relatively equal bargaining strength in effect to make their own law to govern their own particular situations seems as appropriate in the corporate control context as it is in commerical law. This is especially so when there is an absence of empirical data indicating which fixed rule is best. Cf. Kripke, Law and Economics: Measuring the Economic Efficiency of Commerical Law in a Vacuum of Fact, 133 U. Pa. L. Rev. 929 (1985).

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tional shareholder voting are maintained, the approach to corporate structure in this area should place a strong priority on flexibility.

Such flexibility has been the traditional hallmark of state law. State corporation statutes should explicitly address the problem of tender offers, as they do shareholder voting, mergers, and sales of assets. State legislatures should enact default regulatory provisions, and perhaps in some cases minimal requirements. As to the approach that should be taken in these provisions, I am inclined to think that those advocating the auction, with generally passive behavior on the part of target management, have the better argument, at least when it comes to formulating a rule that represents the best approach for most corporations. Perhaps as a matter of public policy, sunset provisions requiring stockholder reapproval every so often would be advisable.[210] But all state laws should contain provisions forbidding nonstructural defensive tactics and any structural defenses not specifically approved in either the statute or charter.

Before states may resume their hegemony over regulation of corporate acquisitions, however, federal law will have to permit them to do so. In *Edgar v. MITE Corp.*,[211] the Supreme Court cast considerable doubt upon the ability of states to regulate tender offers.[212] Although the Illinois statute at issue in *MITE* applied to corporations that were not incorporated in Illinois and had relatively minor contact with it,[213] subsequent lower federal court decisions have read *MITE* broadly and struck down, on preemption or commerce clause grounds, state antitakeover statutes that applied only to corporations incorporated within the state.[214]

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[210] The SEC Advisory Committee Report, supra note 1, contains suggestions along these lines.

[211] 457 U.S. 624 (1982) (plurality opinion).

[212] A majority of the Court held that the Illinois statute in question, which required a bidder to give the target notice of its intent to launch a tender offer 20 days in advance, during which time the bidder was prohibited from communicating its offer to the shareholders, was an unconstitutional burden on interstate commerce. Id. at 643-46. Justice White's plurality opinion also found the statute preempted by the Williams Act. Id. at 634-40. Only two other justices, Chief Justice Burger and Justice Blackmun, joined the preemption part of Justice White's opinion.

[213] The Illinois Business Take-Over Act applied to non-Illinois corporations that were targets of a tender offer if either Illinois shareholders owned 10% of the class of securities sought in the tender offer or the principal office of the corporation was located in Illinois and at least 10% of its capital was represented within the state. Id. at 627.

[214] See, e.g., Fleet Aerospace Corp. v. Holderman, 796 F.2d 135 (6th Cir. 1986) (invalidating Ohio Control Share Acquisition Act); Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) (invalidating Indiana statute that applied only if target was incorporated in Indiana and met other shareholder and business contact requirements with the state), prob. juris. noted, 107 S. Ct. 258 (1986); Terry v. Yamashita, 643 F. Supp. 161 (D. Haw. 1986) (finding unconstitutional Hawaii Control Share Acquisition statute that applied only if target was incorporated and had its principal place of business in the state and at least 100 of its shareholders were state residents); APL Ltd. Partnership v. Van Dusen Air, Inc., 622 F. Supp.

These decisions have failed to consider the relationship between tender offers and negotiated mergers analyzed here. It makes little sense to allow states to regulate virtually all aspects of corporate merger decisions and procedures (other than disclosure and antitrust law), but to prohibit such regulation of tender offers. If provisions allowing for special shareholder votes in the context of tender offer transactions violate the commerce clause, then presumably so do supermajority merger vote provisions and perhaps even staggered elections of the board of directors. The interstate character of the market for corporations is no less pronounced than that of the market for the securities of those corporations. State law, under the aegis of the "internal affairs" doctrine,[215] has traditionally regulated the relationships between shareholders, directors, and the corporation. It should continue to do so.[216]

1216 (D. Minn. 1985) (invalidating Minnesota Control Share Acquisition Act that applied only if corporation had at least 50 shareholders in Minnesota and either was organized under Minnesota law or had more than $1 million in assets in Minnesota). Indeed, the district court judge in *Fleet Aerospace* expressed the view that *MITE* "sounded the death knell for state control of federally regulated tender offers." 796 F.2d at 139 n.5 (quoting district judge's unpublished opinion). The Sixth Circuit, although affirming the district judge's decision, expressed "reservations" about this comment, "if the court meant by this statement that *all* state regulation regarding tender offers is foreclosed." Id. (emphasis in original).

There is already considerable literature discussing the constitutionality of these so-called second generation antitakeover statutes. See, e.g., Block, Barton & Roth, State Takeover Statutes: The "Second Generation," 13 Sec. Reg. L.J. 332 (1986); Profusek & Gompf, State Takeover Legislation After *MITE*: Standing Pat, Blue Sky, or Corporation Law Concepts?, 7 Corp. L. Rev. 3 (1984); Sargent, Do the Second-Generation State Takeover Statutes Violate the Commerce Clause?, 8 Corp. L. Rev. 3 (1985); Note, The Demise of State Takeover Regulations, 11 N. Ky. L. Rev. 613 (1984); Note, Second Generation State Takeover Legislation: Maryland Takes a New Tack, 83 Mich. L. Rev. 433 (1984).

[215] Under this conflict of laws doctrine, the state of incorporation possesses broad latitude to regulate a corporation's "internal affairs," which are generally defined to include relationships among or between a corporation, its officers, directors and shareholders. See Restatement (Second) Conflict of Laws § 302 comment b, at 307-08 (1971); Reese & Kaufman, The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit, 58 Colum. L. Rev. 1118 (1958).

[216] Unfortunately, the Supreme Court muddied these waters to some degree in *MITE*. Justice White, in the part of his opinion that constituted the opinion of the Court, wrote:

> Appellant also contends that Illinois has an interest in regulating the internal affairs of a corporation incorporated under its laws. The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands. That doctrine is of little use to the State in this context. *Tender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company.*

Id. at 645 (emphasis added) (citations omitted). See also Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1280 n.53 (5th Cir. 1978) ("Statutes regulating the internal affairs of a corporation concern the existing relationship between a corporation and its shareholders. Since at the beginning of a tender offer the offeror may be a potential shareholder only, laws governing the offeror's conduct are not logically based on control of internal corporate affairs."). Some of these

Furthermore, while it may be true that the Williams Act was based on a policy of neutrality between bidders and targets,[217] that policy was adopted against the background of state corporate regulation. There simply is no basis in the legislative history or in policy for interpreting the Act as establishing some principle of "neutrality" (however one might attempt to give that term substantive content) on the level of state as well as federal legislation. All the Act requires is that the states not interfere with its disclosure mechanisms and basic tender offer procedures.[218] An analysis of the Williams Act that invalidates state attempts to regulate structural aspects of tender offers leads inexorably not only to a federal law of corporate fiduciary duty, an idea the Supreme Court has explicitly rejected,[219] but also to a federal law of corporate structure and voting.[220]

This is not to say there is no role for federal regulation. Calls for the repeal of the Williams Act, the basic purpose of which is disclosure, are misguided. Furthermore, the aspects of tender offers which necessarily

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language in *MITE* and *Kidwell* casts doubt on the ability of the state of incorporation to regulate the tender offer process itself. The cases should not be read so broadly, however. The Court was certainly correct in finding reliance on the internal affairs doctrine "somewhat incredible" in *MITE*, 457 U.S. at 645, but this finding rested on the Illinois Act's applicability to corporations with little nexus to Illinois. See id. There should be little doubt that states of incorporation can substantially affect the tender offer process by allowing or mandating charter provisions that restrict the rights of majority shareholders or enhance the rights of minority shareholders. The internal affairs doctrine, properly construed, is an implicit exemption from ordinary commerce clause analysis.

[217] See, e.g., Schreiber v. Burlington Northern, Inc., 105 S. Ct. 2458, 2463 (1985) ("The expressed legislative intent [of the Williams Act] was to preserve a neutral setting in which the contenders could fully present their arguments.") (footnote omitted).

[218] Admittedly, this determination will not always be easy. The Ohio statute at issue in *Fleet Aerospace*, 796 F.2d at 135, for example, provided that corporations that had not opted out of the statute would have 30 days in which to approve or disapprove of the acquisition of control. Although such provisions that allow the bidder to acquire shares but limit its right to effect control do frustrate tender offers, we should be hesitant to declare that they directly conflict with the Williams Act, at least when the statutory and charter provisions are in place prior to the commencement of the tender offer. This seems to be the newest strategy in antitakeover legislation. See, e.g., N.Y. Bus. Corp. Law § 912 (McKinney 1983); Va. Code Ann. § 13.1-725 to 1-728 (1985).

[219] See Schreiber, 105 S. Ct. at 2463 n.8; Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977).

[220] Relegating takeover regulation largely to the states is not without its shortcomings. States may be inclined to enact antitakeover provisions not because shareholders want them but rather because management prefers them (and the state caters to management, which controls incorporation and reincorporation decisions), or because the state wants to protect home-state corporations from being acquired by foreign firms. See, e.g., R. Nader, M. Green & J. Seligman, Taming the Giant Corporation 33-61 (1976); Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974). Moreover, a hodge-podge of state provisions arguably renders the securities markets less efficient. But that is already the case, and at least for the time being the choice we have made. Any company needs to consult the corporate charter and state laws to find out the procedures for seizing control.

take place in federally regulated securities markets, such as the procedures and timing for tendering, should continue to be regulated by federal law. Nevertheless, the analysis presented here suggests that flexibility even with regard to these procedures may be desirable, and thus lends support for a proposal put forth in a recent SEC concept release on takeovers.[221] The SEC invited comments on "self-governance exemptions" to the recently adopted "all holders" rule[222] as well as other Williams Act provisions. Thus, it would be possible to retain federal regulation of certain aspects of tender offer procedures, while still allowing firms the structural flexibility currently enjoyed under state law.

I offer here only the outline of a new approach to the problem of tender offer regulation. It is perhaps disheartening after years of debate and millions of dollars of empirical research not to have a firm and single answer to this problem. But the assumption upon which most of the scholarship and research is founded, namely, that there is a single optimal rule for all firms, is likely erroneous. Tender offers serve the same basic function as mergers, and their regulation will inevitably affect the market for acquisitions generally. The variation in the source and amount of gains in corporate acquisitions suggests that procedures that result in different distributions of those gains between the acquiring and acquired corporations will have different efficiency consequences. In the absence of any convincing evidence that such acquisitions should be subject to uniform mandatory procedures, corporations ought to be free to adopt those corporate structures that they believe maximize shareholder welfare.

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[221] Exchange Act Release No. 23,486, 51 Fed. Reg. 28,096 (1986).

[222] Exchange Act Release No. 23,421, 51 Fed. Reg. 25,873 (1986). The all holders rule requires that tender offers of issuers and third-party bidders must be open to all holders of the class of securities subject to the offer.

The Validity of Profits-Structure Studies with Particular Reference to the FTC's Line of Business Data

By GEORGE J. BENSTON*

The simple proposition that consumer-damaging collusion is more likely to occur when there are fewer competitors has given rise not only to legal restrictions of economic activity thought to restrict output, but also to an enormous amount of empirical work attempting to relate market concentration to the exercise of monopoly power.[1] Most such studies measured market structure by an index of concentration (for example, four-firm concentration or Herfindahl) and performance by accounting profit (for example, net profit divided by assets) or price-cost margins (sales less direct costs divided by sales). From the positive, statistically significant correlations often found between greater concentration and profit (with other factors presumably accounted for), some researchers conclude that increases in concentration are anticompetitive and that concentration, therefore, is bad.

The concentration-profits studies have been criticized essentially on two grounds. One is that the positive relationship is not indicative of collusive behavior. In particular, Oliver Williamson (1968), John McGee (1971), Harold Demsetz (1973, 1974), and Sam Peltzman (1977) point out that higher profits could result from efficiencies experienced by large firms, which resulted both in greater market shares and high levels of concentration. Analytical arguments show that higher profits logically follow as much from lower costs that are associated with higher levels of concentration, as from collusion-determined higher prices. Some empirical evidence that supports this belief is presented by Demsetz, Peltzman, and Bradley Gale and Ben Branch (1982). However, their findings have been contested on the grounds that the data used are biased or inadequate, or that the researchers have not demonstrated that the observed higher-profits/greater-concentration relationship was caused by lower costs.[2]

The second criticism is that available data provide an inadequate basis for such conclusions. The concentration numbers are based, usually, on industries defined by the Commerce Department's Standard Industrial Classifications (SIC). The SIC definitions tend to be supply (production) rather than demand determined, include nonhomogeneous products, and exclude sales of similar products that are included in different SIC groups or are imported. The profit data are taken from accounting reports that provide poor measures of economic values. Weiss (1974) describes many of these problems. However, he does not believe that these shortcomings invalidate the studies. As Weiss (1979) concludes:

> I argued that the crudeness of the concentration data, the increasing diversification of firms, and many distortions in accounting profits all bias the observed relationship between concentration and profits towards zero. Because of these biases, I argued that the effect [of a significant positive relationship] was probably understated when observed, and that it might well have been present when it was not detected.
> [pp. 1106–07]

Largely as a consequence of these problems (particularly the increasing diversification of large companies that made their reported profits and other data difficult, if not impossible, to link with measures of market concentration), the Federal Trade Commission (FTC) designed and implemented a large scale program to gather detailed data from large companies by lines of business (*LB*).[3]

Originally, the program sought to collect data from some 2000 companies on their revenues, expenses, and assets, allocated to 357 lines of business. After vigorous protests, culminating in an unsuccessful 1975 challenge in the Washington, D.C. District Court, the program was scaled back somewhat, and 450 of the largest industrial companies were required to file reports on 267 FTC-designated lines of business (that follow the SICs) for 1974 through 1977. (Partial reports also were filed for 1973.) These data are much more extensive and detailed than have ever been collected by a public agency. Through September 1983, the FTC published five *Statistical Reports*, and forty papers and reports based on the data have been written by its staff and outside economists.[4] Thus, there is a substantial basis on which the usefulness of the program, and of profit-structure studies in general, can be judged. Considering the large number of observations, the detail, the cost of the data, and the qualifications of the economists who used them, an analysis of the inputs and outputs of the *LB* program can serve as a general critique of the very large body of empirical work that is based on company accounting numbers and data classified by SICs.[5] It also can put into context the large number of studies and other analyses that have been and are likely to be generated from the FTC's *LB* data, since these numbers are on computer tape and are being made available to approved researchers and published in tabular form by the FTC.

I. The *LB* Program's Purposes

The first *Statistical Report* published under the FTC's *LB* program reiterates the purposes for which *LB* data were to be used.[6] According to the FTC staff, "The Line of Business Program is designed to elicit information vitally needed in evaluating industry performance" (FTC, 1981a, p. 2). These data, they say, will serve the following purposes:

> 1. *Antitrust Enforcement:* "Knowledge of industry performance is essential to efforts of the Commission to direct its activities towards industries where poor performance suggests the need for more detailed investigation and possible enforcement action."
> [p. 3]
>
> 2. *Allocation of Private Sector Resources:* (a) "Managers and directors of corporations will be able to evaluate the performance of their own enterprises against industry averages;" (b) "investment analysts and investors are likely to find *LB* reports useful in evaluating the prospects of particular industries."
> [p. 4]
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> 3. *Aid for Economic Research in Industrial Organization:* "And, like economists within the FTC, outside scholars

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[1] See Leonard Weiss (1974) for a review of 46 papers, a presentation of a 47th, and a footnote mention of 8 more, which he notes excludes studies on banking markets. For a review of 15 additional studies on banking markets, see my article (1973). Weiss (1970) also reviews many of these studies but does not find them largely inadequate, as I do. Since the time of these surveys, many more similar papers have been published, of which a few are reviewed below.

[2] See F. M. Scherer (1979b), who shows how the industry output and price statistics used by Peltzman are likely to be biased. Scherer argues that product innovations rather than production efficiencies are causally related to higher profit rates. He does not provide similar (or any) evidence showing that the higher profits are due to collusion.

[3] A resolution of the alternative (efficiency) explanation of the data might also have been a goal, but it was not mentioned in the FTC's Statements of Purpose. See my article (1979, pp. 61–65) for a review of these statements. Also see Federal Trade Commission (1981a, pp. 1–7), which repeats the purposes of the program and does not explicitly mention the efficiency-profits-structure hypothesis.

[4] At least 19 of these have been published or accepted for publication.

[5] From 1978 though 1981, 112 econometric studies in industrial organization were published, according to a review of the *Journal of Economic Literature* and the Index of the *Harvard Business Review* (William Long et al, 1982, p. 141; the papers are listed in their appendix D).

[6] See FTC, 1981a, pp. 1–6.

> will use the Line of Business aggregates as a basic data source for advancing the frontiers of knowledge in the field of industrial organization." [pp. 4–5][7]

It is clear that the *LB* program requires numbers that adequately reflect the desired *economic* market values. Moreover, to be useful for the purposes delineated, the economic market values would have to separate the present values of gains from monopoly power from those due to other causes, such as luck or disequilibrium.

II. The Usefulness of the FTC's Line of Business and Similar Data for Evaluating Economic Performance

The validity of company accounting data for economic analyses, such as those to which the FTC's *LB* program is directed, would be best determined with tests of prediction. However, these require a measure of "true" economic value, which (to my knowledge) is not available. Hence, two procedures (followed in Sections II and III) are employed. In Section II, accounting numbers, as they are reported to users of published financial statements and to the FTC, are analyzed a priori to determine the extent to which these numbers appear to reflect economic market values. This exercise is undertaken because, as is discussed in Part A, accounting biases are unlikely to be randomly distributed with respect to most of the variables of interest for testing structure-performance hypotheses. The analysis of accounting biases that follows in Part B shows why researchers would find it very difficult, if not impossible, to measure and adjust for the biases, even were much firm-specific information available. The empirical procedures employed by FTC economists to overcome two problems, overhead allocation and transfer pricing, are considered here. In Part C, the degree to which the data are contaminated and incomplete, given the FTC's (SIC) definition of industries, is assessed.[8] Some evidence supporting the concerns about the data is presented in Part D. In Section III, the application to hypothesis testing of the accounting numbers collected by the FTC is evaluated, to determine whether the researchers were able to overcome the severe shortcomings of the data that are delineated in Section II.

A. *The Interaction of Accounting Measurement Biases and Measures of Performance*

The analysis presented below shows that differences between accounting measures and economic market values are likely to be significant and very difficult (in many important instances, impossible) to determine. However, were they randomly distributed with respect to variables of interest, the result would only be noise or possibly spurious correlations. It is doubtful, though, that such randomness occurs, for the three reasons outlined next.

First, several studies have shown that firms' choices of accounting procedures are functions of their size, propensity to be regulated, management profit-sharing plans, debt covenants, and tax situation. For example, Ross Watts and Jerold Zimmerman (1978) find the larger firms and those more likely to be regulated tend to choose accounting methods that result in lower reported profits. Robert Hagerman and Mark Zmijewski (1979) find that systematic differences in the accounting

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[7] In the FTC's previous releases, which also stress these purposes, mentioned additionally are improvements in the government's efforts to control inflation and unemployment, aids to small business firms and to buyers and sellers of goods, facilitation of labor unions' bargaining by providing them with information on profits, and information to farm groups that will help them in dealing with suppliers and processors. For references to the relevant documents and critique of the aims of the program, see my article (1979). Also see William Breit and Kenneth Elzinga (1981). For an opposing view, see Scherer (1979a).

[8] The poor conformance of four-digit SIC-defined markets (which the FTC uses to define lines of business) to homogeneous industries is discussed and demonstrated by Weiss (1974, pp. 194–96), Betty Bock (1975), and my article (1979, pp. 66–78), among others. (See fn. 49 below for a very brief description of five such "industries.") Therefore, though this problem is severe, it is not analyzed further here. An additional bias is the restriction of the program to large firms.

methods adopted are related to whether the firms are management controlled or owner controlled. Robert Holthausen and Richard Leftwich (1983) report that the presence of debt covenants affected the accounting procedures used. Unfortunately for researchers who would use accounting data, these biases need not be constant. For example, if a firm is in a steady state, profit understated in an earlier year results in an overstatement in a later year, *ceteris paribus*. Other combinations of effects can occur, as is discussed below. Thus, even if these biases were known and identified with specific firms, the researcher must also deal with the effects of past decisions to adopt alternative accounting procedures.

Second, alternative accounting procedures need not be consistently applied by all firms in an industry. This is likely to be a greater problem when industries are defined by SIC codes. It is exacerbated further when industries are formed by aggregating the FTC-defined *LB*s of different firms, firms with accounting practices determined by their original industry status. For example, Eastman Kodak may have adopted firm-wide accounting methods that are appropriate for a film and camera maker, but its chemical activities are aggregated by the FTC with those of, say, Union Carbide which may use methods appropriate for a chemical manufacturer that specialized in batteries. Additionally, centralized firms that do not allocate expenses, assets, and capital to product lines may be compared with decentralized firms. As a consequence the former report higher price-cost margins (P/S) and returns on assets (P/A), *ceteris paribus*, where costs are defined as allocated expenses. Furthermore, to the extent that accounting biases are industry related, observations from different industries cannot be compared or pooled without the differences being adjusted for.

Complicating matters further, the FTC's rules permit firms leeway in assigning their data to specific SIC codes. Consequently, accounting differences among a changing sample could be responsible for the considerable changes (reported in Part D below) in the aggregate industry ratios published by the FTC in its *Statistical Reports* (1981a, b; 1982). These are the data that will be available to non-FTC researchers and other users. The potential for drawing incorrect inferences from these data would appear to be considerable.

Third, there is reason to believe that accounting mismeasurement of economic market values is associated with some commonly used measures of company performance. For example, a concentrated industry may be one in which only a relatively few firms compete because a large investment in fixed assets is required. If the values of these assets are understated, perhaps because they are recorded at amounts that do not reflect inflation, depreciation also is understated. Consequently, such measures as P/S and P/A will be positively associated with concentration, *ceteris paribus*. Similarly, if a few companies dominate an industry because they previously invested in intangibles (such as patents, industrial processes, marketing networks, and advertising), the current reported P/S and P/A will be overstated. Thus market share and profit rates will be positively associated, *ceteris paribus*, though not as a consequence of market power. Indeed, if the amounts expended on intangibles were correctly accounted for, it might be that the aquisition of a large market share was a negative present value investment. Unfortunately, this bias need not be stable. For example, the reported P/S of a growing company could be understated. (These possibilities are discussed further in subsection B1.)

As a further example, it may be that executives who manage lines of business with large market shares are compensated, in part, with a share of accounting profits. In a particular year, they (and their bosses) may find it desirable to show larger profits. Or companies with *LB*s that show large market shares may be those that experienced a surge in demand, perhaps because the prices of substitutes increased. If these companies allocated overhead to product lines as a fraction of direct costs, their product costs would not increase as much as their revenues. Hence P/S and P/A would be positively associated with higher market shares, *ceteris paribus*.

But the relationship would not be as positive had they allocated overhead according to sales dollars. In either event, a measured association between profits and market shares would reveal nothing about market power or efficiency.

Many more examples could be given to explain measured relationships between accounting profits and concentration or market share. Therefore, researchers who would use company accounting data should at least attempt to adjust for biases or show that these are not important. On the first point, the following analysis demonstrates that the required adjustments are very difficult or (in many important situations) impossible to effect. Though some researchers who use accounting numbers profess awareness of the inherent biases, they do not seem to realize just how complex the situation is.

B. *Company Accounting Data and Economic Market Values*

The extent to which accounting data differ from economic market values is presented in subsection 1. The usefulness to companies of these data, despite their considerable divergencies from economic market values, is explained in subsection 2.

1. *Divergencies of Accounting Data from Economic Market Values.* For present purposes, only the generally most important sources of divergencies are considered.[9] These include: (a) the values of long-lived tangible assets and their depreciation or depletion over time; (b) the value and amortization of intangible assets (for example, advertising and research and development); (c) inventory values and the cost of goods sold; (d) allocation of common and joint costs to lines of business; and (e) intrafirm transfers among lines of business. For each, the reasons for the divergencies are delineated first, followed by an evaluation of the extent to which the reported numbers can be adjusted to approximate economic market values and the effect of the remaining biases on two commonly used measures of economic performance, the profit rates on sales and assets. The conclusions of the analysis are summarized in Table 1 and an analytic estimate of the cumulative impact of the accounting biases is given in subsection (f).

(a) *Long-Lived Tangible Assets and their Depreciation or Depletion Over Time.*[10]

Accounting Procedures. Accountants do not attempt to record, initially, an asset's economic value to a firm, but, rather, the amount paid for it as measured in objectively determined monetary units (market value). An asset's economic or present value (value in use) to the firm should be greater than or equal to its market value (value in exchange), since otherwise the asset would not have been purchased. The difference could be due to nonacceptable (for example, illegal monopoly power) or acceptable (for example, specialized use of resources) rents. Neither is recorded at the time of the transaction.

Where an asset is constructed rather than purchased, the recorded amount is likely to understate its competitive market value, since the seller's selling and administrative costs and total cost of capital rarely are recorded. But an asset is never capitalized (recorded as an investment) at more than its recorded cost, and, when the asset could have been purchased at less than the amount expended to make it, accountants charge the excess to expense (the conservative accounting bias).

Understatements of initial asset values are particularly serious for extractive assets. When these assets are fortuitously discovered, at most only the amounts expended for the successful discovery are capitalized. In other cases, the successful efforts method of accounting (used by most larger natural resource producers) capitalizes only the direct cost of discovering and developing successful wells and mines. The amounts spent for unsuccessful efforts are written off (expensed) as current expenses, despite the fact that successful ventures usually are accompanied by unsuccessful ones. Even companies that use the full-cost method (under which amounts incurred for all discovery efforts are capitalized) expense many development costs.

Once the tangible assets have been acquired, the amounts recorded as asset values are expensed over the expected economic life of the assets. The tax regulations usually permit a faster write off, which may also be used for book (reporting) purposes. But a book method may be adopted that yields currently higher reported net income. In any event, the depreciation method chosen is not designed to measure the user cost of the assets—the change in the asset's present values—in part because these calculations are too difficult to make, and in part because the accountants who must attest to the numbers would find such calculations uncomfortably subject to manipulation.

The recorded numbers also are not adjusted to reflect changes in the capital values of the tangible assets. Such changes could occur as shifts take place in the supply and demand for the assets, the factors used with the assets for production, and the goods produced.[11] When the changes are due to monopoly power or collusive pricing, the

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[9] For a much more detailed and differently structured and directed analysis, see my article (1982).

[10] The discussion in this subsection applies generally to the following subsections. Hence it is relatively long.

TABLE 1—THE EFFECT OF SOME DIVERGENCIES BETWEEN ECONOMIC VALUES AND ACCOUNTING NUMBERS ON THE RATIOS OF PROFIT TO SALES (P/S)[a] AND PROFIT TO TOTAL ASSETS (P/A)[a]

	Initial Period		Later Periods	
	P/S	P/A	P/S	P/A
Capital Gains—One Time				
Initially recorded assets and increases in present values	*UU*	*U*	*O*	*OO*
Capital Gains and Overdepreciation—Multiple Events				
Stable (uniform distribution of events)			*N*	*O*
Declining			*O*	*OO*
Growing			*U*	?
Expected Inflation	*N*	*N*	*O*	*OO*
Unexpected Inflation	?	?	*O*	*OO*
Intangible Assets				
Stable (current expenditures equal depreciation)			-	*O*
Declining			*O*	*OO*
Growing			*U*	?
Cost of Goods Sold and Inventories				
Prices increasing steadily:				
Last-in, First-out			*N*	*O*
First-in, First-out			*O*	*O*
Prices decreasing steadily:				
Last-in, First-out			*N*	*U*
First-in, First-out			*U*	*U*
Overhead allocations among products			?	?
Allocation of Joint and Common Costs and Assets to *LB*s			?	?
Intrafirm Transfers Among *LB*s				
Contamination due to Assignments to *LB*s			?[b]	?[b]
Transfers priced at other than market			?[b]	?[b]

Notes: *U* = understated; *UU* = very understated; *O* = overstated; *OO* = very overstated; *N* = not affected; ? = bias unknown.

[a] Profit is before interest and income taxes.

[b] Probably not very great on average.

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[11] For example, the 1970's increase in the market price of oil increased the values of oil and gas reserves, substitutes such as coal, and fixed-price contracts to purchase these resources.

economist interested in these events would not want the values recorded as ordinary assets, since all firms then would be measured as earning zero profits. Therefore, the reasons for the change in values would have to be specified and their effects measured.[12] In any event, the accounting values are not changed.

The monetary values of assets also change as the purchasing power of money changes. While estimates of the effect of general price level changes now appear in the published statements of large companies, usually by the application of indices, these adjustments are not often made a part of a company's accounting system and individual asset accounting numbers are rarely changed. Furthermore, current values are not recorded, largely because the cost of such adjustments is greater than their value to most companies.

The magnitudes of the divergences between accounting numbers and economic market values cannot be determined.[13] An estimate, perhaps, could be made if one could obtain estimates of the current market values of individual assets. Even then, the assets' economic (present) values to the firm would not be measured, nor would the extent to which the present values are due to presumably unacceptable (for example, collusive pricing) or acceptable (for example, entrepreneurial skill) behavior. Furthermore, market-revealed values are unlikely to occur for most user-constructed assets. Even general adjustments in the magnitudes, perhaps with some index, would require detailed information about purchase dates, current equivalents in terms of production, and the economically correct depreciation procedure to be applied. Such knowledge is impossible or very expensive to obtain.

The Effect of the Biases on Measures of Economic Performance. Although there is no practical way to convert accounting asset values and depreciation to economic values or to separate the causes of changes in values, those who want to use these numbers claim they could be useful if the direction and rough magnitude of the biases could be stated. But, as the following analysis shows, the effect of the biases on two commonly used ratios—operating profit to sales (P/S) and operating profit to total assets (P/A)—is not determinable.[14]

As noted, increases in the value of long-lived assets are not recorded, resulting in understated profit and asset values. Consequently P/S and P/A are understated (assuming P/A is less than 1.0). Subsequently, profit and P/S and P/A are overstated, since depreciation on the higher unrecorded asset value is not recorded, and the asset remains understated. Unrecorded decreases in assets values have the opposite effect.

The effects become more complicated when the initial events and changes in asset values occur more than once, as is likely. Even if the events occurred uniformly over time, and

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[12] The effect of monopoly on asset values could be (and has been) measured by relating changes in the market value of assets to changes in laws or firm behavior (for example, mergers) that are hypothesized to result in monopoly. These studies include taxicab licensing, stock exchange regulation, and lawsuits filed by the Department of Justice. None of these studies use accounting data. See G. William Schwert (1981) for references and a discussion of the methodology.

[13] Some economists (such as James Buchanan, 1969, and others whose essays are reprinted in Buchanan and G. F. Thirlby, 1973) believe that economic values (particularly costs) cannot be measured conceptually, since they depend on subjective evaluations of alternatives.

[14] See Ezra Solomon (1970) and Thomas Stauffer (1971) for formal proofs. Franklin Fisher and John McGowan (1983) show that the divergence between accounting and economic rates of return are likely to be nonpredictable and nontrivial. Gerald Salamon (1973) criticizes researchers who attempted to relate the firm accounting rate of return (P/A) and internal rate of return (IRR) by assuming that the firm IRR is equal to the IRRs of the firm's projects. Salamon shows that "...if the growth rate in gross investment (g') is greater than or equal to the IRR of firm projects (r_i') then the IRR of the firm is not equal to the IRR of firm projects; and in fact, the IRR of the firm is not even defined" (p. 301). Salamon (1985) also shows that an approximation to firm IRR derived from net cash flows is not significantly related to firm size, while P/A is significantly positively related. The measure he employs, though, is based inter alia on an assumed constant growth rate in gross investment and on exponentially decaying (or growing) project cash flows. He warns: "Whether the measurement error from this source [the assumed cash flows] is large or small, systematic or random is pure conjecture at this point."

the effects on profit washed out, assets would continue to be understated, and P/A would be overstated (assuming unrecorded capital gains). But if the events diminished over time, perhaps because of a decline in growth of the company or in relative prices, unrecorded depreciation probably would exceed unrecorded capital gains. Hence profit would be overstated. The cumulative understatement of assets (which would not be removed until disposal of the assets) would result in a greater overstatement of P/A than in P/S. But if the company were growing or relative prices were increasing, unrecorded capital gains probably would exceed the unrecorded depreciation of past unrecorded capital gains. Thus P/S would be understated. The effect on P/A is uncertain, since both the numerator and the denominator of the ratio are understated.

The effect of general price level changes is different because expected changes do not give rise to economic income or expense. But if the recorded nonmonetary asset amounts are not changed to reflect the current purchasing power of the dollar, an expected inflation results in understated assets and overstated profit (since depreciation is understated). Therefore, with respect to nonmonetary assets, P/S is overstated and P/A even more so. Interest income and expense also are overstated since they include a return on capital. (If the interest expense overstatement were large enough, which is doubtful, P/S could be understated.) Where the inflation is unexpected, though, the company realizes an unrecorded capital loss or gain if it holds nominally denominated assets or liabilities. Thereafter, its interest income, interest expense, depreciation, and assets are understated. The effects on P/S and P/A thus depend on the extent to which it holds nominally denominated assets and liabilities. If the unrecorded capital gains exceed the capital losses, the first-period P/S is understated; P/A is understated if the unrecorded gains were large enough. In subsequent periods, P/S and P/A are overstated (unless the unrecorded interest income is large enough).

While these biases are generally as specified, the magnitude of the effect varies with several factors. Profit rates and rates of return of companies with longer-lived assets are more affected than those with shorter-lived assets. The amounts invested in long-lived compared to other assets similarly affects the bias. Profit rates are overstated more for rapidly growing than for slowly growing companies. The methods used by the company to depreciate or deplete its assets (for example, straight-line, sum-of-the-years' digits, double declining balance, or units of production) also affects the bias. The times at which assets yield cash flows and the relevant discount rate also affect the difference between the economic profit and rate of return and the accounting numbers. Furthermore, the extent to which the initial period effects occur discontinuously affects the bias.

As is explained above (and summarized in Table 1), except in growth situations the bias in the initial period is the reverse of the bias in subsequent periods. Hence, a large enough change in one period can reverse the sign of the continuing effects of previous periods. In general, then, there is no way to know the sign of the difference between the accounting numbers and economic market values. But the differences are likely to be quite large unless the amount of long-lived tangible assets is relatively small, even without inflation. With inflation, and the nonadjustment of accounting numbers (which especially affect long-lived assets purchased at different price levels), the biases are likely to be considerable. Indeed, a sufficiently high inflation would swamp the other sources of divergence between accounting numbers and economic market values. At the least this means that companies with more tangible assets and assets that are longer lived are more likely to overstate profits and rates of return on assets. In the absence of this overwhelming inflationary effect, the direction of the bias cannot be stated a priori, nor does there appear to be any practical way to adjust the reported *LB* and other company accounting data to reflect desired economic market values.

(b) *The Value and Amortization of Intangible Assets.*

Accounting Procedures. The amounts spent for intangible assets—such as advertising, goodwill, research and development, and employee training—are recorded as current-period expenses in accordance with the "generally accepted accounting principles" of the Financial Accounting Standards Board. Although a large portion of these expenditures clearly results in assets, the amounts are not recorded as such because the present values of the resulting assets are difficult to measure objectively, and managers could use the estimates to manipulate reported profits and assets. Even when estimates were made objectively, the likelihood that they would turn out to be wrong is considerable. Subsequently, even honest estimates could appear to have been deliberately misstated to fool users of the company's financial statements. To protect the independent auditors who attest to the statements, and as a means of demonstrating that auditable measures of the present values of intangible assets cannot be made, all expenditures on such assets (i.e., intangibles) are recorded as expenses by accounting fiat.

The Effect of the Biases on Measurements of Economic Performance. The effect on recorded profit of not capitalizing intangibles depends on their past and current amounts and the rate at which they depreciate. Several economists have attempted to estimate the numbers, an exercise that requires some heroic assumptions. For example, Weiss (1969) assumed a constant annual growth rate of advertising and a constant rate at which past advertising expenditures depreciate. Robert Ayanian (1975), using those assumptions, showed that the rate at which advertising is assumed to depreciate is critical for calculating the economically correct rate of return. He estimated the depreciation rate by assuming a multivariable Cobb-Douglas production function for advertising. To estimate the parameters, ten years' data were required. William Comanor and Thomas Wilson (1979) dismiss his results because they believe that advertising generally depreciates very rapidly. But the studies they cite are no better than Ayanian's in measuring the depreciation rate because a basic characteristic of intangibles such as advertising is the difficulty, if not the impossibility, of estimating the value of expenditures, future as well as current, even when one has complete knowledge about the company, its environment, and the specific projects and products to which the expenditures pertain. The issue is completely intractable when one must work with data aggregated into SIC-defined "industries."

Given the caveats noted above, several effects of the divergence between accounting numbers and economic values on the profit rates on sales and assets (P/S and P/A) can be specified. If the company is in a stable, zero growth state, such that the amount expended on intangibles exactly equals the depreciation of past, implicitly capitalized amounts, P/S is not affected but P/A is overstated, because past expenditures were not capitalized into assets. If the company's expenditures on intangibles has been declining steadily and the depreciation rate of the intangibles is constant, profit is overstated because the decline in value of past written-off expenditures is greater than the amounts currently charged to expense; thus P/S is overstated. Since assets are understated as long as the past expenditures on intangibles have present value, the overstatement of P/A is even greater. When expenditures on intangibles are increasing and the depreciation rate is constant, P/S is understated. But, since assets also are understated, the effect on P/A is not determinable without additional information. Finally, when the growth rate of intangibles equals the real rate of return, P/A equals the real rate of return.[15]

The amount of intangible assets relative to tangible assets affects the magnitudes of these biases. Importantly, when the assumption of a constant rate of depreciation is false, neither the magnitudes nor the direction of the bias can be determined.

(c) *Inventory Values and Cost of Goods Sold.*

Accounting Procedures. Accountants assign values to inventories according to several rigidly applied formulas that need not depend on the physical movement of the goods. The first-in, first-out method (*FIFO*) assumes that the first goods purchased are the first sold or used in production; last-in, first-out (*LIFO*) makes the opposite assumption. An average of the prices paid is also an acceptable method. Or, when the items in inventory are relatively few and unique, the acquisition prices of the specific goods sold may be expensed as the cost of the goods sold. For all methods, the value of the goods in inventory should not exceed their market values, net of disposal cost. Thus, the amounts considered to be current expenses and the amounts treated as investments in assets (inventory), depends on the accounting method employed and the pattern of prices paid for the goods. None of the acceptable accounting methods records the cost of goods sold at their opportunity costs—the amounts foregone as a consequence of having sold the goods. In most (though not all) situations, this is the replacement cost of the goods. Nor, except possibly in supplementary schedules, are the goods in inventory valued at their market prices.

Several accounting procedures determine the amounts recorded for goods that a company manufactures. In addition to the conventions governing the cost of materials discussed above, some manufacturers use "standard-costing" to assign numbers to manufactured inventories. The standards applied differ among companies. Overhead, especially, is allocated to products according to several alternative criteria. These are usually arbitrary either because there is no conceptually meaningful way to assign costs that do not vary with output or are joint among outputs, or because the cost of determining the association between cost and output exceeds the benefits thereof. Furthermore, to the extent that overhead or direct costs include such accounting numbers as depreciation, the amounts charged to inventories and then to cost of goods sold diverge further from economic market values.

The Effect of the Biases on Measurements of Economic Performance. Short of a revaluation to opportunity costs of inventories and cost of goods sold, there is no way that the reported numbers can be adjusted to economic market values. However, when the prices of materials and other costs of production are stable and equal to opportunity costs, the only important problems are the divergence of internal accounting numbers from economic market values (for example, depreciation) and the arbitrary allocation of overhead to specific goods and processes (unless a company produces only one good or product line in a plant).

When prices are changing, the method of assigning values to the goods sold and to those remaining in inventories becomes important. If prices are increasing steadily, the *LIFO* method will come the closest to recording costs of goods sold at economic market values. But the inventory will be understated. Hence, as long as the physical inventory does not decrease, P/S may be reasonably unbiased; but P/A is overstated. The *FIFO* method tends to value assets at current prices while profit is overstated. Thus both P/S and P/A are overstated. When prices are decreasing steadily, the reverse occurs—the overstatements are then understatements. However, since U.S. companies are legally required to use the same inventory costing method for tax returns as they do for their financial statements, they are likely to use *LIFO* in periods of steadily rising prices and then switch to *FIFO* if they believe that prices will steadily decline. (Taxpayers are permitted one unchallenged switch; they need not use the same costing method for all inventories.) But when price levels fluctuate, the direction of the bias is not unique. The effect of alternative overhead allocations to products is another indeterminate element. This is particularly troublesome for the FTC's line of business data, since information on overhead allocations at the plant level is not reported.

(d) *Allocation of Joint and Common Costs and Assets to Lines of Business.*

Accounting Procedures. Many companies charge costs incurred above the plant level (company-wide costs) to current expense. Others allocate these costs to divisions or plants (rarely to products), using such bases as sales, direct labor cost, labor plus materials (prime) cost, and sales less variable costs

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[15] Ayanian's discussion and illustrations show how difficult it is to make any a priori statements, even when constant rates of growth and decline of intangibles are assumed. Solomon also presents an excellent discussion.

(contribution margin). When company-wide costs do not vary as a consequence of individual outputs or outputs aggregated by lines of business, any allocation method is arbitrary, and profit by product line cannot be determined. The amounts classified as company-wide rather than as plant-level also vary according to the accounting procedures adopted by individual companies. Such considerations as styles of management control, past accounting practices maintained for the sake of consistency, reduction of state taxes, and the degree of decentralized organization dictate the extent to which company-wide costs and assets are assigned to plants and divisions. In addition, the accounting numbers for company-wide assets and costs (such as depreciation of central facilities, general company advertising, and basic research and development) are unlikely to provide valid measures of the economic market costs attributable to products or product lines (as explained above).

Effect of the Bias on Measures of Economic Performance. The effect and direction of the divergence between the reported profit and asset amounts after or before allocations of company-wide costs and assets and the economically valid amounts is not determinable. Most enterprises are not merely mutual funds in which individual companies, each of which produces and sells a line of products specified by the FTC, are joined only by common ownership of a few resources general to all product lines. Rather, products usually are produced and/or sold together because they share joint demands, costs, or both. There is no conceptually valid way (with respect to economics) to allocate these joint revenues and costs to the individual lines of business. And, unless an analysis were made of how the common costs varied with individual products or product lines and could be avoided were production abandoned, there is no way of knowing how closely allocations made via some base, such as sales or direct expenses, approximate the correct amounts. Nor is there any way of knowing what portion of the company-wide costs and assets are joint or common, and how much the accounting numbers diverge from economic market values. Hence the effect of the bias of allocating or not allocating those costs and assets designated as company-wide cannot be determined.

Nevertheless, economists at the FTC argue that, if reported company-wide costs were relatively small, they could be ignored. The FTC's *1974 Statistical Report* (1981a, pp. 62–70) states that 86 percent of the companies reported nontraceable costs.[16] Of these, 62 percent used a single base for making allocations (most used sales), 28 percent used two bases, and 10 percent used three bases. For the entire sample of company *LB*s (each of the FTC-defined lines of business of each reporting company) where a company has more than one line of business, the ratio of nontraceable to the sum of nontraceable and traceable amounts averages 14 percent for total selling and general and administration expenses and 12 percent for total assets. Nontraceable ratios over 20 percent are reported by 26 percent of the company *LB*s for expenses and 18 percent for assets. By *LB* industry aggregates, the weighted average nontraceable ratios are 15 percent for expenses and 13 percent for assets. Ratios over 20 percent are reported for 31 percent of the industries for expenses and 19 percent for assets. Thus, compared to the likely size of net profits, allocated expenses and assets are not negligible.

William Long (1981a) estimated some effects of allocating company-wide costs. (Alternative allocations of company-wide assets were not considered.) He did so by investigating the effect of alternative allocation methods on a regression of profit/sales on seventeen variables, using company *LB* data. Profit originally was calculated as gross profit (sales plus transfers less cost of sales) less direct and nontraceable expenses as allocated by the reporting companies.[17] When nontraceable selling and administrative expenses were reallocated according to sales or a sales-dominated base, the coefficients were not altered much, a result which is not surprising since 69 percent of the companies allocating common costs used sales as their allocation base and most of the balance included sales in their bases. However, the effect of allocating these costs randomly (which, in the absence of theory or evidence on how the nontraceable expenses vary, has about as much validity as the other methods), Long reports, "is large and disasterous. The F-ratio plummets. Coefficients change signs. Significance levels are altered" (1981a, p. 21).[18]

Additional insights are obtained from an in-depth study of the financial data of six large companies by Robert Mautz and Fred Skousen (1968).[19] They recorded the net profit of company-determined business segments (three to nine segments for each company, thirty in all) as measured by each company's allocations of noninventoriable common expenses (excluding income taxes). Then they calculated the segment net profit after allocating the common expenses according to four additional, commonly used allocation bases (sales, total assets, number of employees, gross profits, and combinations thereof). The common expenses allocated are relatively less than in the FTC data set, averaging 3 percent of total expenses compared to 14 percent for the *LB* data,[20] probably because the company-determined segments tend to be broader than the SIC-determined *LB*s. Consequently, Mautz and Skousen's allocations probably understate the magnitudes of the effects on net profit that might be found in the FTC data. Even then, the alternative allocation procedures yield very different rates of return (profit/assets). The differences can be summarized by dividing the range of the alternatively calculated returns by the company-determined return for each of the thirty business segments. (In percentages; a quotient of 0 means no difference among the alternatives.) The distribution of these percentage quotients is as follows:

0 to 5 percent–3 segments (10 percent);
6 to 10 percent–4 segments (13 percent);
11 to 20 percent–9 segments (30 percent);
21 to 40 percent–4 segments (13 percent);
41 to 60 percent–2 segments (7 percent);
61 to 80 percent–1 segment (3 percent);
141 to 843 percent–7 segments (23 percent).

With five observations deleted, four from the company with a very low percentage of common expenses and another with a very low company-determined profit rate, there are no observations in the 0–5 percent category, three instead of four in the 6–10 percent category, and six instead of seven in the over 141 percent category.[21]

Thus calculated product-line profit rates appear to be sensitive to the way indirect expenses are allocated, even when commonly used allocation methods are employed. Nor is there any a priori reason to favor one allocation method over another or even to know whether any of the methods yield economically meaningful numbers. Rather, the determinants of these expenses within each company should be analyzed empirically, a process that cannot be undertaken with the data requested by the FTC. Even then, where such expenses are jointly determined there is no conceptual way to assign them to specific products or product lines.

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[16] The 1975 data are similar; see FTC (1981b, pp. 54–59).

[17] The original regression was run by David Ravenscraft (1982).

[18] Long (1981a) also reallocated nontraceable advertising and other selling expenses and recalculated the equations he had calculated for another paper (1980). However, only an average of 3.6 percent of these costs are nontraceable and few (less than 10 percent) of the regression coefficients estimated are significant at the 5 percent level. Hence, though he found few significant changes in the coefficients and other statistics, the finding is not of much value for the present question. Stephen Martin (1981b) uses alternative definitions of total assets (for example, traceable and traceable plus nontraceable) as variables in regressions. Since he does not employ alternative allocation methods for nontraceable items, his results are not relevant here.

[19] Mautz and Skousen state that, although their sample was not randomly selected, "[t]ogether the six companies represent a broad cross-section of American industry" (p. 19).

[20] One company had common expenses of only 0.5 percent of total expenses. With this company excluded, the average is 3.7 percent.

[21] See my article for details (1979, Table 1-2).

(e) *Intrafirm Transfers Among Lines of Business.*

Accounting Procedures. Intrafirm transfers that are not priced at the opportunity value of the goods impart a mismeasurement of the sales of the sending business unit and the expenses of the receiving unit. For example, when transfers are priced at, say, cost rather than a greater market value, the sending unit's sales and the receiving unit's costs are understated. Because transfers at other than market prices could be repriced only at prohibitive expense, the FTC permitted respondents to report data as per their books, but also asked them to report the transfer pricing method. Transfers from one line of business to another are reported by 80 percent of the companies.[22] Of those transferring among lines of business, the transferred amounts (weighted by sales plus transfers, hereafter denoted as sales) average 8.9 percent of sales. Transfers above 9.9 percent of sales are reported for 24 percent of the company lines of business. Goods transferred to foreign activities (which are not included in the *LB* data) average 3.5 percent of sales (Ravenscraft, 1981, Table 1). Thus transfers, while not great on average, are not negligible. Furthermore, differences in tax rates and bases among states and countries affect transfer pricing practices, which impart a systematic bias to the profits data.

The companies reported that they made 39 percent of their transfers at market prices. Cost plus markup was used in 26 percent of the transfers, cost was used for 13 percent, and "other" for 22 percent.[23] About half the companies used more than one transfer pricing method.

Effect of the Bias on Measures of Performance. The size of the bias imparted by intrafirm transfers at other than market prices is analyzed by Ravenscraft (1981). For each company *LB* (3186 observations), he calculated the percentages to sales of transfers out and in that were priced at cost, cost plus markup, and other. These percentages were included as independent variables in regressions of *LB* profitability (profit/sales) on market structure and other variables. The coefficients of these variables show that, where transfers were at other than market, the profitability of the sending *LB*s is significantly lower and the profitability of the receiving *LB*s is significantly higher. Thus, the method of valuing transfers does matter. But he also finds that few of the coefficients of the other variables are affected; for all but two (rather unimportant) variables, the differences are negligible.

Ravenscraft also attempted to correct *LB* profits for transfers at nonmarket prices.[24] This adjustment was only partially successful; several of the measures of the transfers at nonmarket prices remained statistically significant in estimating profit/sales.[25] In comparison with Ravenscraft's original regression, the general conclusions were not altered appreciably, though several coefficients changed significantly.

Ravenscraft reports that the profit/sales measure (which the FTC claims would be useful to analysts) is changed as follows:

> The average absolute change in operating income to sales for the 702 *LB*s is .0259, with a maximum change of .2540. In percentage terms, the average change in operating income to sales is 445%, with a maximum change of 17,595%. [This is an average of the fifteen largest changes—so the actual maximum is higher.] The correlations between the original and reallocated profits is .8936. [1981, p. 10]

TABLE 2—REPORTED PROFIT RATE ON SALES OR ASSET WHEN COSTS ARE UNDERSTATED OR OVERSTATED BY A PERCENTAGE ERROR*

Understatement (−) or Overstatement (+) of Costs	Actual Profit Rate on Sales or Assets				
	0.05	0.10	0.15	0.20	0.30
−0.30	0.34	0.37	0.41	0.44	0.51
−0.20	0.24	0.28	0.32	0.36	0.44
−0.10	0.15	0.19	0.24	0.28	0.39
−0.05	0.10	0.15	0.19	0.24	0.34
+0.05	0.00	0.06	0.10	0.16	0.27
+0.10	−0.05	0.01	0.07	0.12	0.23
+0.20	−0.14	−0.08	−0.04	0.04	0.16
+0.30	−0.24	−0.20	−0.11	−0.04	0.09

*Calculated with formula derived in fn. 18.

On the industry level, the two measures of profitability are highly correlated at .99. The average absolute change in the ratios is .0033; the average absolute percentage change expressed as percentages of the ratios is 11.5. But among the 237 industries reported by the FTC, there are some dramatic changes. The 10 industries with the largest changes show an average absolute percentage change of 170 percent, with a maximum of 590 percent. Thus individual profitability numbers can be considerably affected by transfers at other than market prices.

(f) *The Cumulative Impact of Accounting Biases.*

The extent to which accounting numbers diverge from economic market values cannot be determined, either as to magnitude or sign, but the effect of specified percentage divergencies can be determined analytically.[26] Table 2 shows the reported profit rate on sales or assets that results from a given percentage error in costs, compared to the "actual" profit rates. Divergencies due to nonmarket priced transfers and arbitrary allocations and mismeasurements of assets are ignored; Fisher and McGowan show that divergencies of accounting from economic depreciation alone is sufficient to make the accounting rate of return diverge significantly from the economic rate of return on assets. Even with these potentially important measurement errors implicitly assumed to be zero, the effect of an error in measured cost as small as ±.10 changes an actual profit rate of .15 to .07 or .24. A ±.20 error results in a stated profit rate of −.04 or .32 rather than .15. Consequently, it seems evident that data measurement problems certainly might swamp inferences that otherwise might be drawn from the reported numbers.

2. *The Usefulness of Company Accounting Data.* From the analysis presented above, it might seem that accounting data are almost useless. In this event, one might ask, why do companies spend great sums to record, analyze, and report such data? The reason is that even if these data do not provide good measures of economic market values that are appropriate to other issues, they are useful to

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[22] FTC (1981a, pp. 46–53). The 1974 data are similar.

[23] Ravenscraft reports sales weighted averages of 50.7 percent (market), 25.2 percent (cost plus markup), 9.4 percent (cost), and 14.7 percent (other). He states that "By far the two most common classifications in 'other' are negotiated value and market, list, or wholesale price less discount" (1981, p. 20, fn. 2). These methods apparently were used in about a third of the "other" lines of business. Though these methods seem to be close to market values, his regressions indicate that, in relation to market prices, transfers at "other" prices were lower than transfers at cost or cost plus markup.

[24] The revaluation factor was calculated by dividing those industry sales and transfers that were valued at market by the cost of goods sold plus general and administrative expenses and less the amounts transferred at other than market. By this method, the profits of 22 percent of the *LB*s were reallocated.

[25] Curiously, the coefficients of transfers made at cost and cost plus markup change from significantly negative to significantly positive.

[26] The following symbols are defined for this analysis: S = sales, C = costs, $P = S - C$ = net profits, $ps = P/S$ = profit rate sales, e = error in costs due to arbitrary allocations, etc., as a percentage of costs, C, ps' = reported profit rate on sales when costs are over- or understated by e, and $ps' = (S - C - Ce)/S = ps - e + eps$. Since net profits/assets (pa) is equal to net profits/sales (ps) times sales over assets and neither sales nor assets are assumed to be affected by errors in costs, the effect on pa is the same as the effect on ps. The effect on the profit rate on sales or assets also can be expressed as an amount, s', rather than as a percentage. In this event, the equation would be $e(ps - 1) = s'$.

company managers and outside observers of company activities for several very important purposes. These include internal control for managers and audits of company affairs for investors. These purposes do not require numbers that reflect economic values; rather numbers that reflect market transactions and responsibility for resources are required. When the reported figures are attested to by a certified public accountant, affirmation is made that an audit was conducted by an independent expert who verified the figures and tested the adequacy of the company's financial control system. The accounting numbers also can be evaluated in the context of the manager's or analyst's knowledge about the company's activities and past performance. Thus, the user of the numbers can formally or informally adjust them to account for idiosyncracies in the reported accounting procedures, their company-specific deviations from economic measures, and their relevance to particular questions being asked. (For example, what is the probability that the company can repay debt as promised?) Furthermore, changes in the reported numbers over time, within the context of the past and expected future economic conditions in which the company operates, may provide the user with useful information.

Accounting data also are used for decisions made within the firm, such as output and price decisions, and evaluations of product and managerial performance. For these purposes, the data rarely are used alone. Output and price decisions require estimates of opportunity costs, which often are available only from market data and special studies. Accounting measures of performance usually are evaluated within the context of the environment in which products are produced and managers operate. Thus the accounting numbers rarely are used alone or without specific knowledge of their limitations.

On the other hand, large-scale data bases, such as the FTC's *LB* program set, do not (and, probably even at very high cost, cannot) include much (if any) of the qualifying information available to company managers. When these data cannot be identified by firm name (as is legally required for the FTC *LB* and Census programs), firm-specific information from other sources cannot be brought in. Thus the usefulness of the data for the FTC's announced purposes and for structure-performance studies generally is, at best, doubtful.

C. *The Contamination and Completeness of LBs*

Companies normally do not record data according to the FTC-SIC-defined industries. To make the program feasible, the FTC permits the respondent companies to assign to a single *LB* all the data recorded for each "basic component".[27] Consequently, data properly belonging in one *LB* are reported in a different *LB*, resulting in under- and overstatements.

The FTC has sought to measure the extent by which reported sales data are contaminated and complete with a "specialization ratio" and a "coverage ratio." The specialization ratio is the ratio of the sales belonging in an *LB* category ("primary sales") to the sum of these sales and those included in this category but properly classified in another category ("secondary sales"). These ratios averaged .97 (weighted by total revenues) for the 1975 data; none is permitted to be below .85.[28] Thus, *revenue* contamination does not appear to be serious, except for relatively few industries. The coverage ratio is calculated as the ratio of primary sales reported in a category to the total sales of those products reported in all other categories. The weighted average over industries is .97 for the 1975 data. But 29 percent of the industries have percentages between .80 and .91, and 14 percent have

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[27] A basic component is defined by the *LB* program as the organizational subunit which reports data. A corporate respondent typically has a number of components, and in many cases they cover products classified by the FTC in different *LB*s.

[28] If at least 85 percent of a component's sales is not accounted for by products classified in the same *LB*, the component must be further refined until the 85 percent rule is met. The ratios are described and the figures reported in FTC (1981b, pp. 41–46). The 1974 figures are similar.

percentages below .80. Thus, for a substantial number of industries, this measure shows a fairly high level of incompleteness in the sales reported.

Of much greater significance is the FTC's candid acknowledgement that "whether there is a significant relation between the degree of sales contamination for other variables [for example, expenses and assets] has not been established" (1981b, p. 43). Nor can it be established with the reported data, since the FTC's 85 percent specialization rules do not apply to expenses and assets, which need not and often do not vary directly with sales.[29] Hence, there is no way of knowing how serious the contamination is for such measures of performance as profit/sales and profit/assets.

Nor are these the only types of contamination. The FTC permits vertically integrated companies to combine data that other companies report as individual lines of business into a single *LB*. This contamination is permitted if more than 50 percent of an upstream (earlier processed) *LB*'s net operating revenues come from transfers to a downstream (later processed or sold) *LB*. A similar combination and contamination of data is permitted for backward transfers (for example, wholesaling combined with manufacturing). As a consequence of these permitted contaminations, additional overstatements and understatements of *LB* data will result.[30]

D. *The Stability and Reliability of the FTC's LB Data*

Although there is no way to determine how badly the FTC's *LB* data misrepresent economic market values or are contaminated among *LB*s with respect to expenses and assets, some insight into their validity may be provided by considering the temporal stability of the two key ratios—profit/assets and profit/sales. (Profit is defined as net operating income before interest and taxes.) Academic researchers, industry analysts, and company managers are invited to use the ratios published in the FTC's *Statistical Reports* (1981a, b; 1982). The ratios reported are aggregates of company *LB*s. Thus differences among companies operating in the same FTC-defined industry are averaged. Nevertheless, the reported industry ratios vary considerably among the three (complete) years for which the data have been published—1974, 1975, and 1976. For example, for the ten median ranked industries in 1976, profit/assets for 1976 compared to 1975 changed by a mean absolute of 37.4 percent, and from 1974 to 1975 by 23.0 percent. The mean absolute change in profit/sales of these industries from 1975 to 1976 is 30.2 percent, and 23.3 percent from 1974 to 1975. The changes among years of the ten highest- and lowest-ranked industries are roughly similar. It is possible that changes in the environment in which the reporting companies operated or changes in the sample caused these differences. The errors of measurement described above also could be responsible for the differences between years.

The data reveal an even greater range with respect to the individual company *LB*s that are aggregated to obtain the industry averages and that are used as the dependent variables for several of the statistical studies discussed below. Excluded from these 1975 data are 889 company *LB*s that were not present in the previous year, had nonpositive assets, or were in SICs described as "miscellaneous" and "not classified elsewhere." Profit/sales (profit equals sales less traceable expenses) averages 7.9 percent (Stephen Martin, 1981a, Table 1, 1975 data, 2297 observations). The standard deviation is 14.1 percent, and the range is from less than −125.8 percent to over 58.9 percent (these are averages of the six lowest and highest percentages). Of these, 16.4 percent are negative and 3.0 percent indicate profitability rates of more than 30 percent.[31] Profit/traceable assets averages 23.6 percent (Martin,

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[29] See Bock and my article (1975) for illustrations.

[30] For more on this issue see Bock and my article (1975).

[31] Profitability measured as sales less traceable and nontraceable expenses divided by sales shows a similarly wide range (Ravenscraft, 1982, Table A1).

1981b, Table II, PRA575, 1975 data, 2297 observations). The standard deviation is 170.0 percent and the range is from less than −227.8 percent to more than 2399.6 percent (averages of the six extreme values). Other definitions of assets show similarly wide variations.

If these data reflect the profit rates actually experienced by the reporting companies, it would imply very limited entry and exit into a substantial number of markets. Or, there could be substantial annual random variation in returns, which implies that the data measurement period should be longer than a year. Alternatively, the range of profit rates reported and the number of *LB*s with negative and very high positive profit rates could reflect the effects of accounting practices and allocations to FTC-defined industries. This effect would be exacerbated if the reporting company managers fear that their data will be used against them in antitrust proceedings, despite the FTC's assurances to the contrary. If so, they can avoid reporting profits that antitrust enforcers might consider excessive or predatory in lines of business the authorities might consider to be suspect. Since the reported numbers must be reconciled with the company's total sales, expenses, and assets, the understatement of profits and profit rates in one *LB* results in an overstatement in the other *LB*s. As a consequence, the FTC antitrust enforcers would be misled and the data would be subject to even more noise and biases.

III. Analysis of Economic Studies Based on the FTC's *LB* Data

Though I believe that the biases and shortcomings of reported company accounting data and the FTC's *LB* data delineated above are overwhelming, there are those who strongly believe that these data are valuable if adjusted properly and used effectively. Therefore, the extent to which the reported studies prepared by the FTC's economics staff and consultants can fulfill the purposes specified by the agency are considered explicitly in this section. The working paper status[32] of the studies reviewed should not shield them from public scrutiny, for several reasons. The *LB* program was proposed 14 years ago—in 1970. The costs of the program on the respondents has been considerable.[33] The nature of the data collected has been known since 1974. Hence, it is reasonable to expect the FTC's economists to have had well-structured hypotheses to which the data would be applied. Furthermore, it is useful to analyze working papers because they are more likely to present unsatisfactory and anomalous as well as satisfactory and expected findings than are published papers.[34] In addition, working papers often contain informative descriptions of the data that are not included in the shortened published revisions.[35] Finally, in this case, working papers can influence policy decisions.

The papers are grouped according to the four major study areas toward which the data appear to have been directed: economies of scale; structure-performance; research and development; and advertising and other selling expenses. All of the papers using *LB* data made available by the FTC through

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[32] Several of them have been published, as noted in the references.

[33] See my article (1979, pp. 110–14) for an estimate of the prospective costs. Net of benefits (which were considered to be zero), the present value of the program's cost in 1974 dollars was calculated to be $210 million, based on the FTC staff's estimate of $24,000 per company. This estimate was vigorously disputed by the respondents as being greatly underestimated. See my article (1984) for an analysis of the FTC's and the respondents' calculations of the costs of the *LB* program, which concludes that the FTC staff grossly misestimated the costs.

[34] Unfortunately for the sake of knowledge, papers tend not to be published (or even submitted) unless they reveal statistically significant results that are in accord with accepted hypotheses. For example, Weiss reveals: "An empirical test by Hall and me [Marshall Hall and Weiss, 1967] apparently yielded a mild but significant positive relationship between firm size and profit rates among the few hundred largest industrial firms—a relationship which would have implied a capital-requirements barrier. I am more skeptical now because in subsequent unpublished work I have often found the relationship not to be significant" (1979, p. 1122).

[35] In particular, the published version of Martin (1983) does not include the ranges of the *LB* data, and the published version of Ravenscraft (1983) does not include information on the inter-range distribution.

the date when the *LB* program was to have been evaluated (March 1982) are considered so that readers would not think I had chosen only the poor papers.

A. *Economies of Scale*

Absent analysis of scale economies, there is no way of determining whether a measured positive relationship between profit and concentration was due to some sort of undesirable competitive behavior or to lower costs.[36] Obviously, the policy implications of these alternative explanations are diametrically opposed. Unfortunately, neither the paper reviewed next (the only one to address this question), nor any other study based on the *LB* data, can provide a meaningful measurement of economies of scale.

1. In "*Economies of Scale, Concentration, and Collusion*," Dennis Mueller (1980) states his objective as follows: "What we seek to explore in this [61 page] study, therefore, is the extent to which the efficiency-concentration-collusion interrelationships can be disentangled using data as disaggregated as the *LB* data are" (p. 5). Mueller attempted to estimate a Cobb-Douglas production function by regressing value-added (sales less materials) on payrolls, net plant and equipment/payrolls, and (in some equations) advertising/payrolls. He had to "assume that labor and capital stock are somehow pre-determined and exogenously given for any cross-section year" (p. 8). As an alternative measure of economies of scale, he regressed total cost on sales. The equations were run for each *LB* industry, the observations being company *LB*s, 1974 data. The estimated alternative measures of scale economies are weakly and negatively correlated, which is an indication that the models are poorly specified. But a much more important criticism is that neither of these forms could be meaningfully specified. The dependent variables, sales less materials and total costs, are determined by the interaction of supply and demand (and, importantly, by the companies' accounting systems). Therefore, even if the numbers used were meaningful measures of economic market values, there is no basis for determining whether the regressions trace out cost curves, demand curves, or the interaction of individual demand and cost curves. Thus there is no valid way to interpret the estimated coefficients.

Despite this crippling limitation, Mueller correlates the mislabeled "scale economies estimates" with several measures of concentration, stating: "If scale economies account for high concentration we expect a positive correlation between [the measures of scale economies and] the various concentration measures" (p. 25). Since the measures could reflect demand as well as supply conditions or simply bad data and poorly structured models, the small and generally negative correlations that he finds cannot be meaningfully interpreted.

In the penultimate section of his paper (ch. 4), Mueller attempts to distinguish collusion and economies of scale by assuming that all firms use the same technology, have the same cost function and the same products, and charge the same price. Given the broad FTC–SIC definitions of industries, these assumptions surely do not apply to the *LB* data set. Nevertheless, after some mathematical manipulations, he concludes: "Thus, while efficiency and collusion factors affect the pattern of costs and sales in a predictable way, their effects cannot be separated without imposing further restrictions and looking at more data than observations on firms within a single line of business" (p. 33). He then imposes several additional assumptions that, in effect, specify all firms in each *LB* industry as homogeneous with respect to economies of scale, degree of collusion, and elasticity of demand. After further manipulations and assumptions about the values of various parameters, Mueller concludes: "Attempts to estimate [the key equations] yielded disappointing results. Convergence was seldom achieved and even when achieved, the asymptotic standard errors often exceeded the regression coefficients. Moreover, whether or not congruence was achieved, the implications of the coefficients obtained were found to vary with the choice of deflator" (p. 47).

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[36] Even then economies of scope are ignored due to the separation of company data into FTC-designated lines of business. Furthermore, other efficiencies could be responsible for higher profit rates, as Peltzman suggests. Or efficiencies in the development and/or marketing of new products could be responsible, as Scherer (1979b) suggests.

Thus the *LB* data are not even amenable to estimating what might be labeled (incorrectly) as economies of scale, without which the structure-performance studies cannot be used for policy purposes. Mueller's study is useful because it illustrates that the unreliability and inherent limitations of the *LB* data severely frustrate even a well-motivated investigator.

B. *Structure-Performance Studies*

1. In "*Structure-Profit Relationships at the Line of Business and Industry Levels*," Ravenscraft (1982) inquires "whether profits rise with industry concentration when other structural variables, such as market share, are appropriately held constant. Also, what economic phenomena underlie the observed profit-market share associations?" (p. 17). Profit is defined as sales less direct (traceable) and allocated expenses divided by sales, as taken from the 1975 *LB* data for 3186 company *LB*s. Profit at the industry level is a similarly measured number derived from the *1975 Annual Survey of Manufacturers* for 258 industries.[37] Those dependent variables are regressed on the fourteen variables listed in Table 3 plus nine additional variables for the company *LB* analysis. The industry regressions exclude the variables that relate only to company *LB*s.

Ravenscraft's study is seriously marred by the conceptual and empirical shortcomings of the dependent variable, profit/sales, which also is used in several of the papers reviewed below as well as scores of others.[38] This ratio is justified as a proxy for the price-cost margin (price less marginal cost over price) —the Lerner Index. However, as Stanley Liebowitz (1984) shows, the Lerner Index is not a conceptually useful measure of monopoly or collusive pricing on which the antitrust authorities might base their actions (an emphasized goal of the FTC's *LB* program). At most, it only measures the marginal elasticity of demand; it does not measure the social cost of misallocated resources or even the amount of profits or wealth garnered from collusive pricing. Furthermore, differences in the price-cost margin among products or over time is a function of differences in marginal costs and exogenous shifts in demand.[39] Importantly for empirical work, as Stanley Ornstein (1975) demonstrates, the profit/sales ratio is not even a valid proxy for the Lerner Index. Recorded and allocated accounting expenses are not the same as economic costs on which the Lerner Index is based.[40] In addition, profit/

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[37] The regressions were replicated with 1974 and 1976 data. With a few exceptions, the coefficients are not significantly different among the samples, and almost all were statistically significant at the .10 level, in part because, as Ravenscraft states, "variables insignificant at the 10 percent level were eliminated by a stepwise procedure" (1982, p. 8).

[38] Profits/assets is not used in any of the FTC-sponsored studies, except as follows. Ravenscraft states that: "With the ratio of operating income to assets as the dependent variable, only three conclusions change" (1982, p. 11, fn. 11). He does not otherwise mention this alternative dependent variable. Martin (1981b) regressed profits divided by six versions of assets as dependent variables. The coefficients of the independent variables differ considerably in significance and sometimes in sign from those of the same variables when profit/sales is the dependent variable. Furthermore, the coefficients differ considerably among the alternative measures of assets, often much more than can be accounted for by scale differences. For example, the Herfindahl index coefficient is statistically significant for only one version of the profits/assets, and three of the six coefficients of market size are significant.

[39] See Liebowitz (1984) for a thorough explication.

[40] Liebowitz (1982) shows empirically that the empirical price-cost margin is not a good proxy for either accounting profit over assets or equity, or a constructed measure of economic profits over sales (which ignores the accounting biases). Martin dismisses Liebowitz's work as follows:

> Liebowitz (1982) criticizes the Census price-cost margin by comparison with Internal Revenue Service data. Scherer identifies two major problems with IRS data: the assignment of entire firms to a single industry (1980, p. 270) and *the impact of accounting rules* which are followed for tax purposes only (1980, p. 272). As noted above, Liebowitz corrects for the first problem (1982, pp. 238–39, footnote 22) [sic, fn. 21]. He recognizes the second (1982, p. 238, footnote 20), and assumes that it can be ignored. There is no reason to think this is the case, *which invalidates his conclusion*.
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> [1983, p. 32, fn. 20; emphasis added]

This criticism is curious, since it appears in a section of Martin's paper headed "The Lerner Index and Accounting Data," in which none of the measurement problems delineated in Section III above are mentioned. Furthermore, the accounting biases in the income tax data, about which Martin expresses concern, are no more serious than the biases in the FTC data that he uses, since the value weighting of the IRS sample overwhelms the additional biases imparted by small firms. Indeed, the IRS data are preferable, since they are not subject to the allocation biases inherent in the FTC *LB* data. (Also see Scherer, 1979b, pp. 200–05, for a demonstration of the biases introduced into industry numbers by the incorrect assumption of homogeneity.)

sales differ among companies according to their degree of vertical integration and the extent to which they employ capital (since the factor price of capital is not included as an expense). Including assets/sales (or assets) as an independent variable to account for the bias is likely to lead to inefficient and biased estimators because the accounting number for assets usually is a very poor measure of the economic value of capital.[41] Indeed, in Ravenscraft's regressions (as in the other researchers' regressions), the coefficient of assets/sales is inexplicably significantly negative. It is likely that this coefficient, and probably others, is due to accounting-based biases.[42] Finally, the relationship between profits/sales and concentration (or market share) should be specified as log linear if it is to serve as a proxy from profits/capital. Ornstein shows that, if this is not done (as it was not in the studies reviewed), statistically significant coefficients incorrectly result.

Aside from (or perhaps because of) the biased numbers used for the analysis, the meaning of the coefficients is difficult to assess. For the company *LB* regression, Ravenscraft finds that "Statistically, the most important variables are the positive effect of higher capacity utilization and industry growth, with the positive effect of market share running a close third" (1982, p. 11). Capacity utilization is measured as the smaller of "one" or the company's *LB* 1975 sales/1974 sales; industry growth is the ratio of the value of 1976 to 1972 shipments. Thus, the greater the increase in company *LB* sales or in industry shipments, the greater the increase in measured profit per dollar of sales. Does margin increase because expenses are less than proportionately variable? Or, were companies in expanding industries able to increase their selling prices more? Or, were industries with higher profit margins on sales able to grow faster?

Interpretation of reported market share is more important because this presumably bears on the profit-structure relationship in which Ravenscraft and others are interested. Ravenscraft expects a positive association of market share with profits for three reasons: "First, *LB*s with a large market share may have higher quality products or market power. Second, *LB*s with larger shares may be more efficient because of scale economies or because efficient *LB*s tend to grow more rapidly. Third, *LB*s with large market shares may be more innovative, or better able to develop innovations" (1982, pp. 2–3). Clearly, these alternative explanations not only have diametrically opposed policy implications (higher market power vs. other explanations), but they cannot be disentangled. In addition, if firms with larger market shares also have been in business longer and have relatively greater investments in fixed assets over an inflationary period, they will have lower depreciation expenses and possibly

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[41] For example, oil and gas producers severely undervalue their major asset, oil and gas reserves, because they do not restate their assets at market values. Worse yet, large companies use successful efforts accounting, wherein only the exploration and development expenses of successful wells are capitalized. Their cost of sales, then, is understated if they use owned oil. But if they use imported oil (which, if purchased, is valued at market), these expenses are higher. If they are decreasing their exploration, drilling, and development activities, their expenses will be lower. Thus, how can the level of their profit rate on sales or, say, the coefficient of, assets/sales, be interpreted? Similar analyses could be made about any company or industry about which one is knowledgeable.

[42] An additional indication of such biases is given in Table 3, which compares the coefficients estimated by Ravenscraft with those estimated by Martin (1981a), who used similar data. (Note that most differences in scaling among the papers were adjusted for.)

TABLE 3—COMPARISON OF COEFFICIENTS ESTIMATED IN FOUR STUDIES USING FTC'S *LB* DATA[a]

Variables	1974 Data		1975 Data	
	Ravenscraft	Martin	Weiss-Pascoe	Scott
Market Share	14.76	10.09	−0.20	0.11
	(5.51)	(2.98)	(6.47)	(1.80)
4-Firm Concentration Ratio	−0.02[b]	−0.11		
	(1.77)	(5.77)		
Diversification (firm)	−1.43[b]	−1.99		
	(1.65)	(1.30)		
Minimum Efficient Scale (industry)	0.18[b]	0.39		
	(2.05)	(2.97)		
Exports/Shipments (industry)	6.51	11.25		
	(1.72)	(2.32)		
Imports/Shipments (industry)	−4.01	−2.05		
	(2.23)	(0.81)		
Buyer Concentration Index (industry)	5.52	0.08		
	(4.48)	(3.60)		
Supplier Concentration Index (industry)	−31.40[b]	−.09		
	(1.39)	(2.58)		
Buyer Dispersion	−0.46	−6.13		
	(0.64)	(4.00)		
Supplier Dispersion	−4.59	−7.20		
	(2.86)	(2.79)		
R&D Expenditures/Sales (*LB*)	−0.47[b]	−0.31		
	(3.68)	(5.62)		
Assets/Sales (*LB*)	−2.40	−5.33	−0.032	−0.0082
	(2.82)	(6.75)	(5.64)	(0.59)
Assets/Sales (industry)	6.00	1.87		
	(4.98)	(1.31)		
Similar Variables				
Selling Expense (direct)/Sales (*LB*)		−0.30		
		(6.74)		
Advertising/Sales (*LB*)	−0.02[b]		0.123	−0.083
	(0.35)		(1.90)	(0.54)
Growth in Demand (shipments)			0.061	0.046
			(10.76)	(3.1)
Distance Goods Shipped			−0.000018	−0.000021
			(3.07)	(1.2)
Number of Additional Variables	9	24	3	3

Notes: Ravenscraft (1982, Table 1, 3186 observations); Martin (1981a, Table 15, corrected for heteroscedasticity, 2297 observations); Weiss and Pascoe (1981, Table 1, equation (4), 3043 observations, scale not given); Scott (1981, Table 7, equation 7–2, 480 observations, scale not given).

[a] Absolute *t*-statistics are shown in parentheses.

[b] Rescaled to Martin's magnitudes.

lower labor and other expenses (as capital is substituted). Consequently, higher market shares will be associated with higher profits, *ceteris paribus*. Or, the reporting companies could have allocated relatively less in common costs to the areas where they have greater market shares. Or, possibly transfers to these units were made at less than market prices. Without more information, implications should not be drawn from the coefficients measured.

Ravenscraft attempts to analyze a presumed market share (*MS*) relationship to profit/sales by regressing profit/sales on *MS* and *MS* times the other *LB* variables. He finds a negative coefficient for advertising/sales, a positive coefficient for industry advertising/sales, and a positive coefficient for the product of advertising and *MS*. He estimated that the *LB* companies made 47 percent of the sales in their industries, on the average, and calculated that profit/sales begins to increase when *MS* rises above 4 percent (p. 17). Assuming that these numbers are valid economic measures, should they be interpreted as meaning that firms with more than trivial market shares charge higher prices, offer higher quality products, economize more on other selling expenses, have a greater investment in capital, or what? Interpretation of the other measured relationships are subject to similar uncertainties.

Thus, despite Ravenscraft's imaginative econometric work, little can be learned, with one exception. He finds that when the company *LB* data are aggregated into industries, the results are different. The coefficient of the four-firm concentration ratio changes from significantly negative to significantly positive (probably, he notes, because company *LB* market share is not included in the industry regression). Five of the coefficients of the fifteen other common variables change from significance to insignificance (three also change sign), and all but two of the balance increase in magnitude by from two to five times. It appears, therefore, that analyses using industry data may have produced misleading results. Or do the regressions using company *LB* data produce misleading results? Or are the companies' allocations to FTC-defined *LB*s causing the differences? Or are the changes in the coefficients caused by differences in the independent variables specified in the company *LB* and in the industry regressions? At the least, these alternatives should lead one to wonder about the usefulness of the output of such exercises for public policy or business decisions.

2. "*Market, Firm, and Economic Performance*" (Martin, 1981a; 1983). Martin attempts to analyze the determinants of the price-cost margins of company *LB*s, where the profits/sales dependent variable was measured as reported sales (including transfers) less traceable expenses only divided by sales. Martin (1981a) specified thirty-two independent variables. Though he considers seventeen of these variables to be endogenous, he estimated simultaneous equations only for the *LB* market share, firm market share, and *LB* selling efforts variables. The two-stage least squares estimates were corrected for heteroscedasticity; the corrected and uncorrected coefficients are presented. The observations are 2297 company *LB*s for 1975. Excluded are *LB*s that were not surveyed in 1974, and observations with nonpositive values for assets (since assets were converted to logarithms).

In Martin's profit/sales regression (1983), twenty of the twenty-seven coefficients reported are statistically significant at the .05 level or better, and four were at the .10 level.[43] Among the findings that might be of interest to the regulatory authorities, Martin finds a statistically significant (.01 level) positive coefficient for *LB* market share and a statistically significant negative coefficient for the Herfindahl concentration index. He concludes that "the market share coefficient may reflect either market power at the *LB* level, or the realization of scale economies, or both" (p. 48). Thus, without further information (which is not obtainable from the *LB* data), this finding is of little public policy value.[44]

Assets/sales, which was supposed to account for the unrecorded cost of capital employed, has a negative, statistically significant (at the .01 level, with the second highest asymptotic *t*-statistic) coefficient.[45] This unexpected result is consistent with the "bad data" hypothesis, since the sign of this variable should be positive.

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[43] He does not state (as does Ravenscraft) whether variables were eliminated with a stepwise procedure.

[44] In his earlier paper, Martin (1981a) attributed the unexpected negative coefficient of the Herfindahl index to a variety of possibilities (for example, suboptimal or excess capacity, X-inefficient, inflation, restrictions on exit following restrictions on entry, and market power expressed as reduced risk). He also recognized that the profitability measure (the dependent variable) does not reflect profit, but the profit rate on sales; hence, he acknowledges, the negative sign "may reflect a more than proportionate impact of market power on sales as compared to profit" (p. 33). However, in the published version, Martin states: "Although a number of ad hoc explanations could be offered for this result, I will not do so" (1983, p. 40). But in his conclusion he states: "The most likely explanation for this result is that oligopolistic coordination is less effective in recession years, while the very barriers to entry which engender market concentration impede exit in the short run" (p. 48). In neither the FTC nor the published version did he consider the possibility that the significant negative coefficient also might indicate misspecification of the model or data that do not reflect economic market values and impart biases.

Two additional facts support the inappropriate model or bad data hypotheses. One is the values of the dependent variable, sales less traceable expenses/sales, which range from at least −125.8 percent to more than 58.9 percent (each are averages of six extreme values). Negative returns are present in 16.5 percent of Martin's observations (1981a; these data are not reported in the 1983 monograph). (Recall that 889 observations were screened out because they were new or labeled as miscellaneous.) As noted above, it seems very doubtful that these numbers could represent meaningful equilibrium economic profit rates. Second, as shown in Table 3, many of the coefficients (adjusted for differences in scaling) and *t*-statistics reported by Martin differ considerably from those reported by Ravenscraft (1982), even though they based their analyses on subsets of the same 1975 *LB* data. (Their dependent variables are somewhat different, since Ravenscraft deducted allocated expenses from sales while Martin did not; but they used thirteen independent variables that are almost identical.) These differences make descriptive statements about the profit-structure relationship of doubtful validity.

The possibility that biases in the data might have been responsible for his results is not recognized by Martin. In his published version (1983; a monograph, not constrained by extreme concerns for space), he hardly mentions biases in the data. Though he has a section partially labeled "accounting data," this contains only a conceptual criticism of Fisher and McGowan and some sentences stating that though "accounting measures…are likely to be…poor measures of the economic value of the capital stock [,] …[t]his point is well known. …[T]his measurement error is a serious problem only if it is systematically related to market structure. It is not obvious that this is the case" (p. 32). But, as is noted above in the discussion of Ravenscraft's paper (1982), such systematic biases could be present.

Furthermore, many of Martin's other findings can be attributed to biases in the data. For example, he reports that "non-advertising sales efforts at the firm level significantly increase *LB* profitability. A firm-level corporate marketing program is apparently a valuable asset, which increases profitability" (1983, p. 41). But, since Martin used *LB* profits before company-unallocated expenses, this finding also could simply reflect differences in accounting practices among companies, where those that allocate less (for example, centralized firms) have, as a consequence, higher measured *LB* profit rates and higher selling expenses at the firm level, *ceteris paribus*. Martin also concludes that "*LB*s which invest heavily in *R&D* are less profitable than other *LB*s, all else equal. This suggests that heavy *R&D* expenditures serve as an index of the intensity of conventional price competition, which apparently serves as a spur for research and development" (p. 42). But, since current *R&D* expenditures are called expenses, the finding might simply reflect accounting practice, and little else. On the other hand, firms that successfully invested in *R&D* in the past do not record the depreciation of this investment; hence their recorded profits are higher, *ceteris paribus*. Just how this might be related to market shares is not clear. In addition, Martin concludes that "a large firm-level *R&D* program enhances *LB* profitability" (1983, p. 46). But again this simply could reflect the interaction of Martin's measure of profitability and accounting allocation practices. Were there sufficient space, similar explanations of many of Martin's other findings could be provided.

3. "*Some Early Results on the Concentration-Profits Relationship from the FTC's Line of Business Data*" (Weiss and George Pascoe, 1981). The authors want to test Demsetz's (1974) hypothesis that concentration-related economies of scale (efficiency),

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[45] Martin (1981b) explored this result more fully by running regressions with six alternative definitions of assets. (Assets defined as all except inventories fit the data best.) The results were substantially unchanged.

superior products or management, or luck is responsible for the often reported positive relationship between concentration and profits. To this end, Weiss and Pascoe regressed profits/sales on the variables listed in Table 3 plus an adjusted four-firm concentration ratio (adjusted "to correct for non-competing sub-products, inter-industry competition, local or regional markets, and imports" p. 2), an interactive concentration ratio equal to the concentration ratio times a ratio of consumer demand to total demand, imports as a percentage of domestic output plus imports less exports, and *LB* market share. The regressions were run with over 3000 observations, each a company *LB*, with 1974 and 1975 data separately. The *LB*s that were new (not reported in 1974) and discontinued (not reported in 1975 or 1976) were excluded, as were extreme outlyers. The reported R^2s range between .04 and .07. The coefficients of market share are statistically significant (*t*-statistics over 5.6) and positive. Those for concentration are insignificant, except for the 1975 data when market share is excluded. The coefficients of the interactive concentration ratio is significant and negative in 1974 and not significant (though negative) in 1975. Thus market share dominates which, Weiss-Pascoe state, "provides some support for the Demsetz-Manke hypothesis, but it is not as compelling as it might have been if the relationship of margin with concentration excluding market share had been stronger" (p. 8).[46]

But, as noted above, profit per dollar of sales of companies in different SIC-defined industries is not a relevant measure, particularly since the coefficient of assets/sales, which is included to correct for the exclusion of the factor cost of capital, is significantly (*t*-statistic over 5.6) negative. In an effort to explain this result, they regress assets/sales on the other independent variables. They offer some speculations about the results, but state: "These are at most hypotheses to be tested on other data and, hopefully, with some theoretical basis" (p. 11). I suggest that the observed and unexplained relationship between profit/sales and assets/sales is a measure of the divergence between economic market values and the accounting numbers used.

4. In "*Multimarket Contact and Economic Performance*," John Scott (1981) is concerned with measuring whether the presence of the same firms in several markets is associated with higher profits and, if so, whether these higher profits result from coordinated behavior, lower costs, or both. To answer these questions, Scott constructed a "new method of assessing multimarket contact" (p. 3). For each of twenty-four lines of business (1974 data) he paired 492 "competing" firms (246 pairs), based on the unverified assumption that firms with sales assigned to the same FTC-defined line of business necessarily were competitors. Then he recorded the number of other lines of business each reported and the number they reported in common. This "frequency of contact" was compared to the number expected if common *LB*s were randomly determined. He finds "significant multimarket contact among sellers" (p. 8), as evidenced from a greater number of observed common *LB*s (37 percent of the pairs) than are expected by chance (.10 level). But considering that firms are more likely than not to produce related products, this result is not surprising nor particularly significant. Also, since fewer than the expected number of common *LB*s (.10 level) were found for 31 percent of the pairs, the distribution is strongly bimodal. This result seems more surprising.

The fifty-one pairs of firms that had more contacts than expected by random selection were subjected to further tests. Scott finds "significantly less advertising and *R&D* intensities [ratios to sales] for lines of business where significant contact occurred" (p. 13). Apparently, firms that operated in related *LB*s experienced economies for some reason. In another test, Scott regressed operating profit/sales on the variables listed in Table 3 plus a measure of industry minimum efficient scale, a dummy variable for the probability of greater multimarket contact above the sample median, and a dummy variable for a four-firm concentration ratio above the sample median. The product of the dummy variables also was included as a variable to measure the interaction of higher contact and higher concentration. The 492 selected firms (246 pairs) are the observations. With respect to his hypothesis, Scott finds significantly (.10 level) greater profit/sales that is about 3 percent higher for the higher-contact/higher-concentration variable. But whether this is due to greater efficiencies, barriers to mobility, collusion, accounting and classification biases, a relationship between vertical integration and number of "contacts," or some other factor cannot be determined from the analysis. Furthermore, as Table 3 shows, there are considerable differences between several of the *t*-statistics and signs of the coefficients Scott estimates and those estimated by Weiss and Pascoe, which renders the findings suspect.[47]

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[46] They also find that "distance shipped" (a measure of geographic market share) is statistically significant (and negative). This is curious since the variable is an SIC industry-wide index based on 1963 data, which should be only tenuously related to the 1974 and 1975 company *LB* dependent variables.

C. *Research and Development*

1. In "*Using Linked Patent and R&D Data to Measure Inter-Industry Technology Flows*," Scherer (1981a) describes the procedures used in gathering data on 15,062 patents issued to 443 large industrial companies during a ten-month period (June 1976 through March 1977) and in assigning each patent to one or more lines of business. The companies' 1974 *R&D* expenditures per the FTC's *LB* reports then were associated with the inventions. The paper is very clear and honest in describing the great difficulties that were experienced in making the required associations. Though he was most imaginative in attempting to solve the problems, Scherer's expression of them makes it clear that they were "solved" only by making some heroic assumptions that severely compromise the meaningfulness of the resulting numbers.

Aside from questions of the meaningfulness of the data, the essential question is why the analysis was undertaken in the first place. In his introduction, Scherer states: "The motivation for developing these new data was straight-forward. During the 1970s... productivity growth [declined]. ...Beginning in the late 1960s,...privately-financed real *R&D* [similarly declined]. ...The key questions remain, what quantitative links exist between *R&D* and productivity growth, and did the parameters of any such relationships shift between the 1960s and the 1970s?" (pp. 1–2). Even if there were no questions about the validity of the data or the presumed decline in productivity, the matrix associating the number of patents issued and expenditures on *R&D* by *LB* that is presented at the close of the paper cannot answer this question since the *R&D* expenditures are not related to changes in productivity. Indeed, at best, all that is learned is that expenditures on *R&D* were made in some FTC-defined industries and that these expenditures *may* have been related to the output of these industries and other industries.

2. "*The Propensity to Patent*," Scherer (1980) uses the data just described because "they are a rich source of quantitative and qualitative information on technological change" (p. 1), and, to a lesser degree, on monopoly power. To these ends, Scherer regressed the number of patents issued to a company *LB* from June 1976 through March 1977 on eight technology class dummy variables, five variables measuring the type and scope of use, two variables designed to correct for some *LB* data reporting characteristics, the percentage of federal funding to total *R&D* expenditures, and a variable described only as "compositions of matter." All of the variables are multiplied by *R&D* expenditures and a constant term was added. The regressions were run with 1819 observations.

How this specification and the reported findings speak to the questions that presumably motivated the study is not clear. If the question asked is whether greater expenditures on research and development are positively related to a greater number of patents issued, an answer would hardly require a

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[47] Differences in the coefficients' magnitudes could be due to the scaling of the variables; the means are not reported.

rigorous empirical study. It seems obvious that if more is spent on research and development, more patents will be applied for and granted. Another unremarkable major finding is that there are differences among industry groups. None of the empirical data provide "information on technological change." Monopoly power is measured by the concentration ratio, which was used to test the hypothesis that firms in more concentrated industries use patents as a means of securing their positions. The statistically significant, negatively signed coefficient would seem to disprove this hypothesis. Or, a critic of business behavior could argue that more highly concentrated industries have erected such great barriers to entry that they need not engage in further patenting. But Scherer dismisses this finding as being due to the highly concentrated automobile industry, which, he says, has few inventions. Or, given the quality of the data, there could be other biases present, as noted above.

3. In "*Inter-Industry Technology Flows and Productivity Growth*," Scherer (1981b; 1982) says that he "exploits a new, uniquely rich data source to analyze the relationships between research and development (*R&D*) and productivity growth" (1982, p. 627). Using the FTC's 1974 *LB* data, he associated *R&D* expenditures (cleverly, but given the nature of the data, necessarily crudely) with originating and using industries. He then regressed two productivity measures on the 1974 *R&D* expenditures divided by value-added and aggregated into two-digit manufacturing groups.[48] The productivity dependent variables are "total factor productivity growth" (not otherwise described) and sales/labor expense, expressed as changes over 1948–66, 1964–69, or 1973–78. Other analyses present simple correlations of various measures of productivity growth with *R&D* by industry of origin and industry of use, broken down into "well measured" and "poorly measured" industry aggregates.

Unfortunately, Scherer infers causation from the correlation of *R&D* expenditures and productivity without providing a supportive conceptual or empirical basis. For example, a company could have higher measured productivity growth in a period which yields higher present or expected taxable profits. As a consequence, it might expend more on *R&D* because this is a tax deductible expense. Thus the higher productivity (and profits) could have "caused" the higher expenditures on *R&D*. Or the company's 1974 expenditures on *R&D* might have been financed from the fruits of past productivity, and directed towards reducing material and capital expenditures and developing new products, rather than towards further increasing labor productivity. In this event, past productivity would be associated with present *R&D* expenditures, but these *R&D* expenditures would not be associated with future measured productivity. Or the regression coefficients simply may reflect mismeasurements. (The productivity measures are very crude.) And the amount expended on *R&D* is unlikely to measure the change in the stock, except in a steady state, at best. In addition, the industry aggregates are rather crudely defined. Therefore the regressions cannot provide evidence on the relationship between productivity and *R&D*, or even on whether research productivity has declined over some time period. Nor is Scherer justified in concluding "that the social returns during the 1970s [on *R&D* investment] appear to have been quite high" (1982, p. 633), since this conclusion is drawn from the coefficients of the regression of the productivity measures on *R&D* expenditures. There is no way of knowing from these data whether there is a causal relationship or even what the social return might have been.

4. "*The Effects of Inter-Firm Cooperation and Economies of Scale on Product Improving Research and Development Expenditures*" (Long, 1981b) begins: "The purpose of this paper is to perform an empirical analysis of the determination of research and development-

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[48] The model calls for percentage changes in the stock of *R&D*, capital/labor and materials/labor. The *R&D* expenditure was assumed to measure the first variable; the other two were omitted.

expenditures for the improvement of the quality of manufactured products in the American economy for 1974 and 1975" (p. 1). For this purpose, Long proposed a model of *R&D* behavior and ran several regressions with data from 205 FTC-defined industries from 1974 to 1975 individually. It is difficult to evaluate the findings of this work, since it is incomplete. One thing that was learned is that the relationship between reported *R&D* expenditures/sales and number of patents issued differs considerably among FTC industries and, remarkably, often is negative and differs in sign between years. It is not clear whether this is a function of some underlying structure or of the quality of the reported data. In any event, it seems clear that the stated purpose of the paper—"the determination of research and development expenditures for the improvement of the quality of manufactured products"—neither was nor, given the FTC *LB* data, could have been fulfilled.

D. *Advertising and Other Selling Expenses*

1. In "*The Size of Selling Costs,*" Weiss, Martin, and Pascoe (1981) seek "to explain selling expenses in manufacturing industries" (p. 5). They regressed advertising/sales, other selling costs/sales, and total selling costs/sales (separately) on five independent variables. The observations are 260 FTC-defined industries (1975 data). The authors learn that all three measures of selling costs/sales are positive significant functions of consumer demand/total demand, the distance products are shipped, and profit/sales—results that are not surprising. But they also find that selling cost/sales declines for concentration ratios greater than .51 for advertising and .39 for other selling costs. The descriptive or public policy implications of this finding (assuming that it is valid) are unclear. Do companies in more concentrated *LB* industries incur less selling expense/sales because they have achieved efficiencies? Or do they compete less in terms of selling expenses? Or have they spent more on selling in the past and now need not maintain consumer acceptance, while companies in less concentrated industries have yet to inform (or possibly influence) consumers? These and other plausible hypotheses cannot be distinguished with the FTC *LB* data.

2. In "*Advertising Intensity, Market Share, Concentration and Degree of Cooperation,*" Long (1980) wants to "assess the role that advertising plays in several explicit models of industrial organization and to formulate procedures for testing hypotheses which that assessment generates" (p. 1). To this end he developed a model which led him to estimate the following equation for each of 32 consumer goods "industries": advertising$_i$/sales$_i$ = $B_0 + B_1$ market share of ith firm, where $i, \ldots, n$ = firms in an industry. The regressions were run with 1974 company *LB* data and replicated in Long (1981) with 1975 data. While the B_0 estimated are quite stable and generally statistically significant, relatively few of the B_1 are significant, and many are inconsistent in magnitudes and even signs between years. Long concludes, "The predicted relation between advertising intensity and market share shows up clearly in only 25% of the cases examined, ...some evidence concerning the presence and impact of cooperation was produced, but it is not clearly persuasive; ..." and "virtually no evidence concerning economies of scale in advertising can be gleaned from this study, given its assumptions" (1980, p. 28). Whether the model tested has been largely disproved, was inadequately specified, or was unsuccessful due to the poor quality of data used cannot be determined. I suggest that if one reads the SIC descriptions of the *LB* industries listed in Long's Appendix B,[49] considerable weight would be given to the last explanation.

IV. Summary and Conclusions

Several factors make aggregates of company accounting-determined data, such as those gathered by the FTC's Line of Business Program, of doubtful value for the purposes of economic analysis. Most important, perhaps, is the fact that the numbers reported, which are derived from the companies' accounting systems, do not reflect economic market values well. The biases caused by the divergencies of accounting numbers from economic values not only are likely to be considerable, but also impart biases to most of the reported numbers, particularly profits and assets. There is reason to expect the errors not to be randomly distributed and to yield measured, though invalid, relationships among the variables that purport to reflect the economic performance of companies in markets.

An additional important error follows from the FTC's use of the SIC categories and from the procedures companies must or can follow in reporting their data. The SIC-designated "industries" yield aggregates that are unlikely to be comprised of products that are substitutes in demand. The FTC's aggregation rules and purposeful reporting by companies that fear the data might be used against them further bias the data, so that it is not clear how well the reported numbers relate even to the industry categories as described in the SIC manual. While the FTC staff made some tests of the extent to which the sales were misallocated, there is no way that they can determine the extent to which expenses and assets were misallocated.

A review of the reported underlying numbers reveals that the variance of such measures of profitability as profit/sales and profit/assets is great. A fairly high proportion of the numbers are negative and the profit rates measured for a number of lines of business is enormously high. It is possible that these data reveal the profit rates actually experienced by the reporting companies and that a year is too short a period for useful measurement. However, I suggest that these data reflect the accounting biases present in the numbers. In either event, it is doubtful whether analyses using these data would yield valid findings.

The twelve studies done by the FTC staff and consulting economists confirm this conclusion. Even aside from the data problems, the potentially important study on economies of scale is fatally flawed in concept. Without knowledge of economies of scale, the profit-structure studies cannot distinguish the effects of efficiency from the effects of collusion on a measured positive relationship between profitability and market structure. But most of the studies use profit/sales as their measure of profitability. It is not clear at all why profit before interest and taxes per dollar of sales is a measure of "profitability" among companies with different accounting procedures that greatly affect the rates. Nor does this metric, even were the accounting biases somehow adjusted, provide a useful measure for public policy or private resource allocation decisions. But these studies do provide some indication of the mismeasurement of the numbers, in that assets/sales was found to be strongly negatively related to profit/sales, while the reverse should be the situation. The studies that relate current expenditures on research and development to patenting and productivity infer causal relationships when there is no reason to expect them from the nature of the data that are or could be used. The studies concerned with selling expenditures are useful only in providing some descriptive data. Considering the limitations of the relatively well done econometric studies that use the considerably improved FTC *LB* data, it seems likely that other studies using less detailed data and often less sophisticated statistical methods are likely to be worse.

A final question that should be confronted is whether meaningful empirical work on the relationship between structure and performance is feasible. The answer, I believe, is that such work is useful, but not in the way much of it has been conducted. Joe Bain's (1951) often cited paper has led many economists to undertake and publish a very large number of misleading studies. These papers present what purports to be evidence that concentrated markets are associated with abnormally high profits, when it is likely that the positive coefficients were simply the re-

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[49] For example, the first five "industries" are the following: meat packing, sausages and other prepared meat products, including bacon, ham, canned meats, and smoked and fresh meats; dairy products excluding fluid milk, including butter, cheese, condensed and evaporated milk, and ice cream; canned specialties, including baby food, baked beans, ethnic foods, health foods, and soup; frozen specialties, including baked goods (except breads), dinners, pizza and waffles; canned, dried, dehydrated, and pickled fruits and vegetables, including preserves, jams, jellies, dehydrated soup mixes, vegetable sauces and seasonings, and salad dressings.

sult of biases in the accounting data used. The consequence not only is a misunderstanding of the working of the U.S. economy, but a possibly misguided antitrust policy that prohibits most horizontal and many other mergers.

If strong and convincing work on the relationships among profits, company size, market share, degree of competition and the like is to be conducted, it must take cognizance of the biases inherent in accounting and other data. It is very doubtful, though, that the required adjustments to the data can be made, particularly when these are aggregated in ways that cannot take account of significant differences among supposedly homogeneous observations. Rather, detailed company and industry studies, which require knowledge of the specifics and dynamics of events and institutions more than of econometric techniques, are needed.[50] In any event, continued sophisticated misuse of biased and irrelevant data is not the answer.

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[50] Scherer's (1979b) delineation of the reasons for increased concentration both illustrates the type of analysis I have in mind and further supports the conclusion that statistical studies which associate variables aggregated by FTC-SIC-defined industries are fraught with error and a considerable potential for misinterpretation.

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"Evidence on Gains from Mergers and Takeovers"

comments by

Michael Bradley* and Gregg A. Jarrell**

The primary purpose of the papers presented in this afternoon's session is to challenge the consensus among financial economists that corporate mergers in general, and hostile tender offers in particular, channel resources to higher valued uses.

This view under attack is nothing more than a simple extension of the neoclassical notion that there are mutual gains from voluntary trade - - - that through the process of voluntary exchange, resources will flow to their highest valued use.

The evidence offered in support of this proposition is the empirical fact that the securityholders of combining corporations realize significant capital gains as a result of these transactions.

It should be noted from the outset that the neoclassical theory of takeovers simply states that corporate acquisitions channel resources to higher valued uses. In its most general form, the theory does not specify the source of these gains. Quoting from my own work:

"The gains from corporate acquisitions may stem from more efficient management, economies of scale, improved production techniques, the combination of complementary resources, increased market power, the redeployment of assets to more profitable uses, or any number of value-creating mechanisms that fall under the general rubric of corporate synergy."

However, several of the authors in today's session have elected to ignore this most general form of the theory and focus on a variant that is attributable to Henry Manne, who was the first to define and articulate the workings of a market for corporate control.

Manne viewed the takeover process as a mechanism for disciplining corporate managers.

However, let me stress that we, along with many financial economists, consider the removal of inefficient target managers to be only one possible rationale for corporate takeovers.

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To put the point more directly, showing that target firms are well-managed prior to their acquisition is not an indictment of the neoclassical theory of takeovers. Indeed, there are well-known cases in which acquisitions were effected specifically to secure the superior management skills of executives of the target firm.

Moreover, it is not clear whether the behavior of inefficient or self-dealing target managers can be detected in the pre-acquisition performance of target firms. It may well be the case that the most egregious cases of inefficiency occur in profitable and growing firms.

Also, the fact that mergers occur in waves with targets clustered in specific industries does not easily conform to the inefficient management theory. These facts are more consistent with the general economic theory , which predicts that sudden and significant changes in the economic environment will trigger a burst of merger and takeover activity, as the pairing of management teams to assets reaches the new (more efficient) equilibrium. Recent merger activity in the transportation and financial services industries more likely can be traced to deregulation rather than to a sudden increase in managerial inefficiency.

Finally, the magnitude of the average takeover premium - - - over 50% since 1980 - - - is hard to explain by the removal of inefficient managers. The size of these premiums must be cold comfort to those who argue that the primary purpose of takeovers is to discipline corporate managers.

The point is that there is no generally accepted theory as to the specific rationale behind corporate acquisitions. To quote from Jensen and Ruback's 1982 Journal of Financial Economics survey paper, "Knowledge of the sources of takeover gains still eludes us." And the fact that we have disguised our ignorance by shrouding it in a fancy term like "corporate synergy" does not edify the issue.

As our presenters convincingly have argued, we must add to the extensive stock market data on takeovers to more fully understand the economic effects of corporate acquisitions.

What is required is an empirical documentation of what assets are redeployed, what operations are discontinued, and what new investments are made in order to generate the observed increase in security values. It is instructive to note that in three recent cases where target managers were able to defeat an unwanted takeover bid (CBS, Unocal and Union Carbide), the target managers essentially mimicked the drastic asset redeployments and share repurchases that had been proposed by the hostile bidders.

Michael Jensen has done some creative work in this regard by providing a logical (if yet untested) rationale for the recent flurry of acquisitions in the oil industry. Professor Jensen is scheduled to present his paper tomorrow afternoon. We applaud this type of research and encourage more of it.

Before I turn to our specific comments on each of the papers let me make a general point concerning the nature of empirical work, particularly since the title of this session is "Evidence on the Gains From Takeovers."

The most important aspect of an empirical paper is that the data be presented clearly and unambiguously so that the reader can judge for himself the veracity of the evidence. The least important aspect of an empirical paper is the author's interpretation of his results. Empirical papers stand or fall largely on the basis of how well the data are presented. A sufficient condition in this regard is to provide enough information so that an independent researcher can replicate the study. A necessary condition is that the author explain fully his research design. The reader must be told how the sample was gathered, what observations were deleted and why, what transformations have been performed on the data and what statistical tests have been used. Sample statistics should be provided so that the reader can get a feel for the data under analysis.

The least important aspect of an empirical paper is the author's interpretation of his findings. Hopefully the research will have been motivated by a specific theory so that interpretation of the results simply involves accepting or rejecting a specified null hypothesis. However, many empirical papers are written and published with little or no explanation of the results. In fact in 1983 the Journal of Financial Economics devoted an entire issue to papers dealing with anomalous empirical findings in finance.

The fact that purely empirical papers are published and widely disseminated throughout the profession is a testimony to the relative unimportance of the researcher's explanation of his findings.

It is our opinion that several of the authors in this session have reversed this priority. Too much ink is wasted on over-interpreting results that are based on data that are not well described. These authors would do the profession a great service if they spent more time describing their data and less time interpreting their results.

Let me now turn to a discussion of each of the papers presented in this session.

MAGENHEIM AND MUELLER

The Magenheim and Mueller paper addresses what we have long recognized is a critical issue in the debate over the economic desirability of hostile takeovers: specifically, do these transactions create value or do they simply redistribute wealth from one stockholder group to another (Roll's Hubris hypothesis)? The answer to this question is central to our null hypothesis stated earlier that on net, hostile takeovers reallocate corporate resources to higher valued uses.

Magenheim and Mueller correctly point out that the issue is an empirical one and centers on the measured gains to acquiring firms, since researchers on both sides of the current debate concede that the stockholders of target firms realize significant, positive gains. Thus the relevant issue, therefore, is how to measure the gains to acquiring firms? What method should be used to estimate abnormal returns and what is the relevant time-frame for such an analysis?

Following standard financial economics, Magenheim and Mueller use stock market data to estimate the wealth-effects of 78 hostile takeovers. It should be noted that these authors disagree with the general conclusion, as summarized in Jensen and Ruback (1983), that there is a significant difference between the returns to acquires in tender offers and the returns to acquirers in mergers: the former being significantly greater.

Using monthly data, they show that indiscriminate use of the market model can lead to different and often conflicting conclusions regarding the profitability of corporate takeovers.

However, having discredited this empirical technique, the authors ignore their own analysis and proceed to use the market model to estimate the returns to acquiring firms.

M&M also show that the time frame used to estimate the gains to acquiring firms is critical in drawing appropriate inferences. Specifically, they find that the longer the period over which the returns to acquirers are measured, the greater the losses incurred by the firm's stockholders.

In the one year following the a hostile takeover, the average acquirer in the M&M sample had lost 11% of its pre-offer value; in the second year following the acquisition, acquiring firms lost an additional 9%; and in the third year acquirers in the sample lost an additional 18%. All tolled, acquiring firms lost 42% of their value over the three years following their acquisitions, which, the authors assert, more than offsets the 81% gain realized by the (smaller) targets of these acquisitions.

Again, I should point out, that the estimates of the returns to acquiring firms are based on a market model that the authors demonstrate is mis-specified and generates negatively biased residuals.

We fully agree that the post-offer behavior of the shares of acquiring firms is relevant to the current debate. And indeed, finding a three-year secular decline in the value of acquiring firms is troublesome for the neoclassical theory - - - troublesome in at least two respects:

First, such a trend is inconsistent with the basic tenets of an efficient capital market. If the Magenheim and Mueller results can be generalized, then market participants can earn an average of 42% abnormal return over three years simply by selling short the shares of acquiring firms. It is troublesome that the market is this inefficient and we are still so poor.

The second troubling aspect of a post-acquisition decline in the value of acquiring firms is that such a secular decline casts doubts on empirical studies that measure the gains from mergers over substantially shorter intervals. Indeed, this is the point of the M&M paper.

However before we start shorting the shares of acquiring firms or rejecting most of the existing empirical literature in this area, let us examine the M&M analysis a bit closer.

The measurement of the economic effects of corporate events has long been an issue in financial economics. It is well known that market model parameter estimates based on monthly data are inefficient and non-stationary. Indeed, that is why the profession has moved towards using daily data. Parameter estimates are much more efficient using daily rather than monthly data.

Moreover, when looking over longer time-periods, one should account directly for changing parameter values or use some other technique for estimating abnormal returns.

Myron Scholes has developed a method for estimating abnormal returns that does not involve estimating market model parameters. Using so-called Scholes' daily excess returns we re-estimated the gains to the acquiring firms in the M&M study. We thank the authors for sharing their data with us.

Consistent with the M&M results we find these acquiring firms, on average, did lose money - - - but far less money than that reported in the paper.

Using Scholes excess returns we find:

6 Months	-1.7 %
Year 1	-2.4
Year 2	-5.0
Year	-6.0

Thus, we find that the acquiring firms in the M&M sample lost a statistically insignificant 15% over the three-year period. This loss is almost 1/3 of the loss reported in the conclusion of the M&M paper.

We therefore conclude that any policy proscription based on the M&M results are compromised severely by the fact that these authors significantly overstate the losses to acquiring firms.

Finally, we should point out that the social desirability of hostile takeovers does not turn on whether or not the stockholders of acquiring firms realize a capital gain as a result of these transactions. Rather, the real issue is whether or not these transactions create total value. In other words, it may well be the case that on average the stockholders of acquiring firms suffer a capital loss but the stockholders of target firms realize an even greater capital gain. In order to answer this question, one must examine the total gains realized by both stockholder groups. Bradley, Desai and Kim (1986) examine 163 "matched pairs" of targets and acquirers and find that on average, (hostile) tender offers result in an 8% increase in the market value of the combining assets. Moreover, even in the subsets of their data in which acquiring firms suffer capital losses, the gains to targets outweigh these loses and the net effect is a significant increase in the value of the combined assets.

RAVENSCRAFT AND SCHERER

By their own admission, the Ravenscraft and Scherer paper sheds little light on the central issue of this conference.

It is not clear what can be learned about the economic effects of hostile takeovers by studying 15 mergers that ultimately led to sell-offs.

This line of inquiry seem analogous to trying to understand the institution of marriage by talking only to divorced people, and to only a few of them, at that.

Moreover, the less than satisfactory way in which the data are described renders almost impossible an independent assessment of their results concerning the profitability of acquiring firms..

For example, the authors casually mention that they "normalize" their data without giving the reader the slightest hint of what actually was done.

They mention the use of a control group that they define as those LOB's in the same industry that had little or no merger activity over the preceding 27 years.

There is no description of this control group nor are sample statistics given. One can only imagine the strange group of LOB's that have had no merger activity over the last quarter of a century.

Data problems notwithstanding, let's review what the R&S paper purports to show:

1. Targets are well-run firms pre-merger.
2. Some acquired businesses are later sold off.
3. Acquiring firms performed relatively poorly in the 74-77 period.

I have already spoken to this first issue: finding that target firms are not on the brink of financial disaster prior to their acquisition is not an indictment of the neoclassical view of takeovers.

The fact that some acquired businesses are later sold off is neither surprising nor very informative.

Finally, the fact that conglomerates performed poorly in the mid to late 70's has been documented by others. Shipper and Thompson for example, attribute this decline in the value of conglomerates to the rash of state and federal anti-takeover regulations that were put into place during this time period.

HERMAN AND LOWENSTEIN

The Herman and Lowenstein paper represents a growing literature that attempts to take the next step in the empirical investigation of the gains from hostile takeovers.

While most financial economists would argue that stock market data are far superior to accounting data in assessing the economic effects of corporate events, most would also agree that examining the latter is not a fruitless exercise.

If corporate combinations do in fact create value, then the accounting numbers of acquired firms should reflect these synergistic gains.

The H&L study examines the accounting numbers of the firms involved in 56 hostile takeovers effected over the period 1975-1983.

They begin by analyzing the pre-acquisition performance of these firms. Like R&S, H&L find that by and large target firms were well-run pre-acquisition.

They also find that targets are no more or no less levered than acquiring firms. Let me make two points regarding their analysis of the leverage issue.

First, H&L argue that the fact that targets are not significantly under-levered is inconsistent with the neoclassical theory of tender offers. In response, let me just suggest that the authors review the neoclassical position on the existence of an optimal capital structure and the potential gains from financial diversification at the level of the firm.

Second, the authors report that the average debt to equity ratio of all the firms in their sample (targets and acquirers) is in excess of 70%. The surprising aspect of their data is not that targets and acquirers have roughly the same leverage, but that the leverage for the entire sample is so high. There is a vast empirical literature on corporate leverage and most of these studies indicate an average debt to equity value of around 40% for non-financial corporation over this period. The H&L estimates are almost twice this amount.

In a soon to be published IRRC paper, John Pound finds that the average debt to value ratio is about 25%, which is comparable to all U. S. manufacturing firms. Pound also finds that targets are indistinguishable along a whole host of accounting measures. In other words, Pound finds that target firms represent a typical cross-section of the firms in the economy.

H&L finish their piece with an examination of the ROE of the 56 acquiring firms in their sample. Much to their surprise, they find that the ROE of half their acquires increased in the years following their acquisitions. However, they elect to ignore these findings and concentrate their discussion on those acquirers that showed a deterioration in ROE.

Based on the results for the latter group alone, they conclude that hostile takeovers are not value-increasing transactions.

Before leaving this paper, let me make one last point. The authors assert that security prices around acquisitions are systematically biased upwards and therefore one must resort to accounting numbers to determine the economic gains to takeovers.

What the authors fail to realize is that this is a testable proposition and especially testable with their sample. Just by chance, these author's have found two groups of acquirers distinguished by their post-acquisition ROE's. An obvious test of the authors' assertion that stock prices are biased is to see whether or not the market was able to distinguish between these two groups when the acquisition was first announced. We suspect that the stockholders of acquirers in the increasing ROE group fared far better than those in the decreasing ROE group around the time of announcement. But, as I said, this is a testable proposition and one that should be tested directly - - - if not by these authors then by someone else.

RICHARD ROLL

Richard Roll's paper is a must read for anyone working in the area. Not because his general thesis is necessarily correct but because he articulates many of the suspicions that we all have with respect to the source of the gains from corporate acquisitions.

It is hard for us who advocate the neoclassical theory of takeovers to understand some of the recent acquisitions and particularly the enormous premiums often paid for target firms.

It's hard to imagine just what synergies were realized in EXXON's acquisition of Reliance, in Dupont's acquisition of Connoco and in U. S. Steel's acquisition of Marathon. And, as you recall, the market was equally skeptical of the value-creating potential of these acquisitions.

Surely, Roll's observation of the hubris attitude of many corporate executives and the persuasive logic of the "winner's curse" explain some of the more outrageous corporate control transactions.

However Roll readily admits that his is not a general theory of takeovers. Quoting from his paper:

"Hubris cannot be the sole explanation of the takeover phenomenon because it implies that every bid announcement should elicit a price decline in the bidding firm's shares. Some papers have even found an average increase. Furthermore, if all bids were inspired by hubris, stockholders could easily stop them by the simple expedient of a prohibition in the corporate charter."

POLICY PROSCRIPTIONS

What then are the policy proscriptions that one can draw from these papers?

As developed earlier, any policy proscriptions flowing from the H&M study are based on overestimates of the losses incurred by acquiring firms. We suspect that if this study were redone using the appropriate empirical techniques, that the authors would find net positive gains to the stockholders of the firms involved in these acquisitions. We suspect that these mergers are not anomalous: Target stockholders probably gained; acquiring stockholders probably did not lose.

The R&S paper has little if anything to say regarding the appropriate public policy towards hostile takeovers.

H&L base their policy proscriptions solely on the subset of acquiring firms in their sample that experienced a deterioration in ROE. They completely ignore those acquiring firms that realized an increase in ROE subsequent to their acquisitions.

This rather selective use of their results notwithstanding, the policy proscriptions advanced by H&L seem to be contradictory to their findings.

Having concluded that hostile takeovers do not create value, H&L proceed to argue that many of the defensive tactics used by target managers - - - greenmail, poison pills, discriminatory share repurchases and scorched earth tactics in general - - - should be outlawed. This seems to us to be a complete non-sequitor.

If hostile takeovers do not create value but rather represent a drain on society's resources, then why should defensive tactics be prohibited? It seems to us that if one believes hostile takeovers to be welfare-decreasing transactions, then one should encourage the development and proliferation of these and other anti-takeover measures.

Perhaps the best summary of the public policy implications of the papers presented in this session is found in Richard Roll's assessment of the current state of empirical work on the gains to corporate mergers and acquisitions. Quoting from his paper:

"From the policy perspective, there is no empirical justification for limiting takeover activity because of potential damage to target firm shareholders. Furthermore, there is no good empirical justification for restricting the activities of bidding firms."

Both Gregg and I would be interested to know if Professor Roll feels compelled to rewrite this passage in light of the evidence presented here this afternoon. We strongly suspect that he does not.

ECONOMIC STATISTICS: WHY THEY OFTEN LIE

Those government-issued numbers on which so many business judgments, plans, and forecasts depend are often seriously defective. Blame bureaucratic inertia as well as budget cuts.

■ *by Irwin Ross*

TO ANYONE who believes economic statistics, the announcement from the U.S. Bureau of the Census last September was a bit of a shocker: its monthly figures on imports were way off. The snafu developed because the Customs Service, which collects the raw data, could not get all its paper to the Census Bureau on time. It was still operating a cumbersome manual system of data collection. As a result, each month's totals included imports from prior months. Delayed reports for August, say, swelled the import figures for September and October. Over a period of two years, anybody trying to track trade performance on a monthly or even quarterly basis was badly misled.

Among the deluded was the Commerce Department's Bureau of Economic Analysis, whose initial reports on GNP growth were far too high for the last quarter of 1984 and far too low for the first quarter of 1985, largely because an enormous volume of December imports was erroneously credited to January. After the bureau made the adjustment, GNP growth in the fourth quarter shrank from 4.3% to 0.6%, while growth in the first quarter of 1985 swelled from 0.3% to 3.7%. People at the Bureau of Economic Analysis must have been relieved to learn that at last the Customs Service is acquiring an automated system to process information on imports.

That little horror story is perhaps the most dramatic example of the eroding reliability of U.S. economic statistics. The subject is finally getting some national attention, in part because of the Census Bureau's candor in confessing its goof. In March the Joint Economic Committee of Congress held a widely publicized hearing on the problem.

The basic trouble is that the world has changed and statistics have not all kept up. "Too many statistical series are outmoded, and there are too many data gaps," says Courtenay Slater, former chief economist of the Commerce Department, in a report prepared for the Joint Economic Committee. "Information about new industries and rapidly growing economic sectors is often scanty and sometimes misleading."

To a considerable extent, the statistical lags result from budgetary constraints. Cutting began in the Carter Administration and went deeper under Reagan. The Gramm-Rudman-Hollings act is forcing an across-the-board 4.3% cut on all agencies. Some deficiencies, however, such as the failure of price indexes to deal adequately with changes in quality, long antedated the financial pinch.

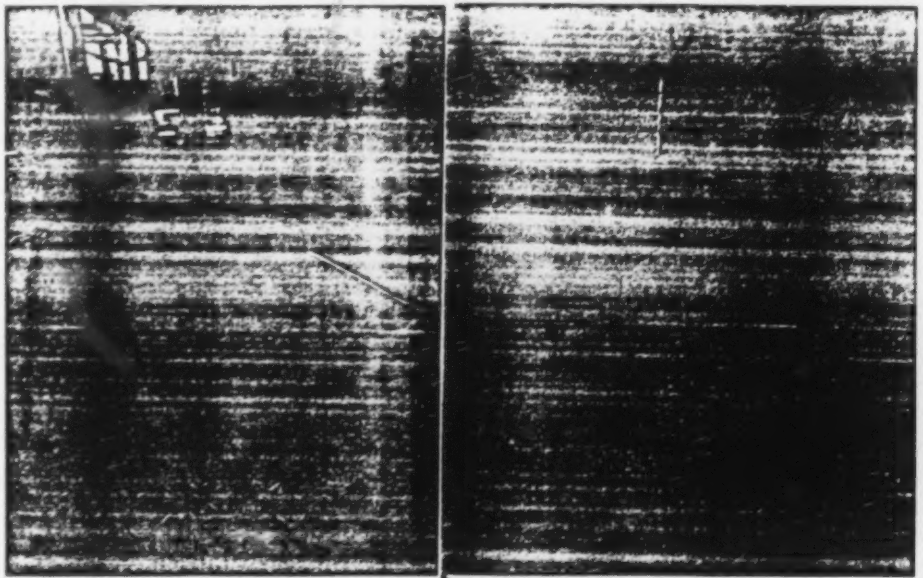
In any account of obsolescent statistical systems, that vast compendium known as the Standard Industrial Classification (SIC) must head the list. A compilation of 1,005 numerical industry codes, the widely used SIC was designed to classify business establishments by their economic activity, thereby facilitating the collection, tabulation, and analysis of all sorts of data. Obviously any classification system has to be reasonably current to be of value, but the last major revision of the SIC code was published in 1972. A revision was to have been undertaken in 1982, but the Administration declined to put up the money.

The present SIC manual is in many ways only of antiquarian interest. It has a separate code number for "extraction of pine gum" but not for manufacture of computers. At long last the Administration has decided to undertake a revision. Proposed changes were published in the *Federal Register* for comment. A total of 78 industries are to be eliminated as stand-alone categories with their own code numbers, and 79 new industries are to be recognized as distinct for the first time. Out as stand-alones are "rock salt," "artificial flowers," and "billiard and pool establishments." In are "travel agencies," "videotape rentals," and "animal aquaculture" (mostly fish farming). "Management, consulting, and public relations" will be divided into four separate industries and "engineering, architectural, and surveying services" into three. If all goes well, the new manual will be out next year, 15 years after the old one.

The consumer price index is also out of date—a matter of moment not just to economists and statisticians. Some 37 million recipients of Social Security have their payments adjusted annually by the CPI, as do military and federal civil service retirees. Some 20 million food stamp recipients see their allotments shift with the CPI. A rise of a single point in the index means a $4.6-billion increase in the federal deficit, according to the Office of Management and Budget.

As newspaper readers are reminded every month when the new CPI number comes out, the index is based on a "market basket" of the goods and services purchased by a typical urban dweller—a basket that was first put together in 1972-73. Here we are 13 years later with the same shopping list and the same weighted averages, even though that typical urban consumer is likely to have changed his spending habits considerably. For one thing, stores now offer a host of new electronic wares to spend money on. New consumer products not in the CPI include videocassette recorders, personal computers, and compact-disk players. Since the index does not reflect the decline in per capita energy use since 1973, it gives too much weight to energy prices. Retreats in prices of gasoline and fuel oil largely accounted for the CPI's 0.4% dip in February, the first downtick since December 1982.

The Bureau of Labor Statistics freely admits that the 1972-73 market basket is out of date. Indeed, the bureau has been engaged in a five-year project to design a new basket to reflect consumption patterns in 1982-84. The job required a comprehensive household survey of consumer expenditures to discover



The consumer price index begins with the painstaking price-chopping of around 400 field representatives. Phyllis Ryer checks 18 or so outlets a week in New York City.

Research Associate Lorraine Carson

PHOTOGRAPH BY ANGEL FRANCO—VISION PHOTOS

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what people were spending their money on. The revised CPI will be out in February 1987.

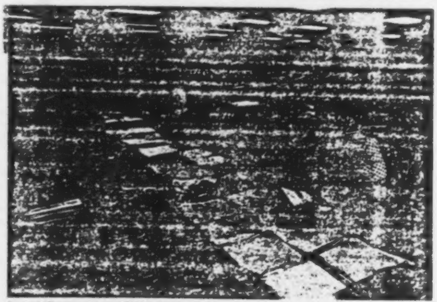
The other major drawback in the CPI is that changes in quality largely elude it, a problem as old as the index. If the quality of a product improves as its price rises, the true rise is obviously less than the nominal rise. It is generally agreed that the BLS does an excellent job of adjusting for quality in automobiles through a complex process of pricing components; the auto companies cooperate by furnishing a lot of data. But with other consumer durables, the same painstaking analysis is only infrequently applied—for reasons of methodological difficulty as well as cost. For services, the BLS makes only scattered efforts to assess quality. How would the BLS go about tracking quality in dry cleaning, for example? Obviously by close scrutiny over a period of time in many places. That would be fearfully expensive.

THE PRODUCER PRICE index (PPI), which these days gets a lot of attention as an indicator of ebbing inflation, has a major deficiency of its own, apart from the fact that it also reflects 1972 weights. The index covers only commodities, yet the service sector, including trade, communications, transportation, and finance, accounts for almost half of GNP and more than 70% of business employment.

The BLS has long been aware of the slighting of services, and in 1984 Congress appropriated $750,000 as seed money toward adding coverage of services in various statistical series, including the PPI. Since then the BLS has received a trickle of additional funds, totaling $2.3 million. The money is largely for research on how to do it rather than for doing it. Incorporating the service sector into the PPI would probably cost as much as the present index—$14 million a year, according to Kenneth Dalton, associate commissioner of labor statistics in charge of price indexes. In the present budgetary atmosphere, nobody is proposing that.

The employment statistics do not suffer from underfunding, but they are far from problem free. They often give off confusing signals. Over the past four years, and particularly since mid-1984, the two BLS measurements of employment—the household survey and the business establishment survey—have been seriously out of sync. The establishment survey estimates the number of payroll jobs through a questionnaire sent to a sample of 260,000 companies. At the same time, interviewers question a sample of 60,000 households to determine how many members are working or have actively sought work in the preceding four weeks.

The establishment survey picks up only wage and salary workers and thus is expected to report a lower figure than the household survey, which includes the self-employed, farm workers, and domestics. When these groups are deducted, the household total should logically show about the same number of payroll jobs as the establishment total. Yet it does not. Adjusted household employment is substantially lower, and the gap is widening. In November 1982 households reported 3,142,000 fewer wage and salary jobs than establishments did. By January 1986 the gap had widened to 4,230,000, a 35% increase. BLS experts speculate that a household member who is reported as employed may actually hold two jobs and that the number of moonlighters has been increasing. But there is no question on the interview sheet that would elicit information about dual jobholders. Perhaps a question or two should be added.



Import figures are compiled from customs data at this Census Bureau center in Indiana.

By all accounts, the index of leading indicators is in especially bad shape. Produced monthly by the Bureau of Economic Analysis, it combines 12 series—among them new orders, net business formation, and building permits—that are supposed to herald up or down movements in the economy. The index does so only on occasion and with such variable lead times as to be of little value. The main problem, according to Feliks Tamm, the official who gets out the index, is that it has not been revised since 1975. "There is hardly one series that we are completely satisfied with," he says.

Improvements do occur in the statistics the government puts out, but slowly. Late last year the Bureau of Economic Analysis introduced an index for computer prices. In the past it had no method for evaluating quality changes, so it simply held prices constant to compensate for improvements. When the bureau finally developed a sophisticated index, it discovered that with computing power taken into account, computer prices had dropped at a rate of 18% a year between 1972 and 1984. This revelation had a pronounced effect on the widely followed price index for producers' durable goods, reducing its rate of increase over that period from 6.9% to a mere 1.8%.

A widely welcomed change was the recent demise of the "flash" estimate of the current quarter's GNP. Released in the final month of the quarter, the flash was partly based on projections from the first month's data and partly on the second. It was almost always grievously off the mark, but not predictably in one direction or the other. The Bureau of Economic Analysis began publishing the flash in 1983; before that it had been furnished to other government economists and had invariably leaked. Last January the Commerce Department mercifully killed it. But that solution can hardly be invoked for most of our statistical problems. ■